ORIGINAL

Before the
COPYRIGHT ROYALTY JUDGES
LIBRARY OF CONGRESS
Washington, D.C.

In the Matter of	Docket No. 2006-3 CRB DPRA
Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding	

SECOND AMENDED PROPOSED RATES AND TERMS OF THE DIGITAL MEDIA ASSOCIATION

Pursuant to section 351.4(b)(3) of the rules of the Copyright Royalty Judges (the "Court"), 37 C.F.R. § 351.4(b)(3), and the Court's Order of May 27, 2008 on the Joint Motion to Adopt Procedures for Submission of Partial Settlement, the Digital Media Association ("DiMA"),[1] joined by AOL, LLC; Apple Inc. (f/k/a "Apple Computer, Inc."); MediaNet Digital, Inc. (f/k/a "MusicNet, Inc."); and RealNetworks, Inc., who have each filed individual notices of participation in this proceeding,[2] submit the enclosed amended proposed rates and terms excluding settled issues.

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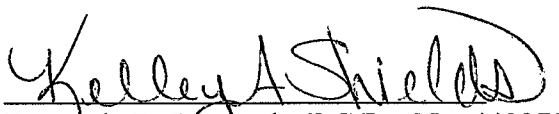
[1] Established in 1998, DiMA is a national trade organization devoted primarily to the online audio and video industries, and more generally to commercially innovative digital media opportunities.

[2] Napster, LLC and Yahoo!, Inc. each filed individual notices of participation and joined DiMA's Written Direct Testimony but have since withdrawn from the proceeding.

Respectfully submitted,



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July 2, 2008

Counsel for The Digital Media Association

SECOND AMENDED PROPOSED RATES AND TERMS OF DiMA

Add the following to Chapter III of title 37, Code of Federal Regulations (tentatively numbered part 380 for purposes of reference):

PART 380 – RATES AND TERMS UNDER COMPULSORY LICENSE FOR MAKING AND DISTRIBUTING A DIGITAL PHONORECORD DELIVERY

Sec.

§ 380.1 General.

This part 380 establishes rates and terms of royalty payments for all copies made in the course of making and distributing phonorecords, including by means of digital phonorecord delivery, in accordance with the provisions of 17 U.S.C. 115.

§ 380.2 Definitions.

(a)(1) *Applicable receipts* means that portion of the money received by the licensee, or licensee's carrier(s), from the provision of a digital phonorecord delivery that shall be comprised of the following:

(i) revenue recognized by the licensee from residents of the United States in consideration for the digital phonorecord delivery in accordance with the provisions of 17 U.S.C. 115; and

(ii) the licensee's advertising revenues attributable to third party advertising "in download", being advertising placed immediately at the start, end or during the actual delivery of a digital phonorecord, less advertising agency and sales commissions.

Note: Notwithstanding (i) and (ii), above, the licensee may pro-rate or allocate revenue on the basis of total usage of digital phonorecord deliveries of sound recordings or on any other reasonable basis that fairly and accurately reflects the revenues attributable to particular uses. For example, if revenue is received for a bundle or package, the licensee may allocate revenues on the basis of usage (if DPDs comprise half of total usage, then half of all revenues are attributed to them).

(2) Applicable receipts shall include such payments as set forth in paragraph (a) of this section to which the licensee, or licensee's carrier, is entitled but which are paid to a parent, majority-owned subsidiary or division of the licensee.

(3) Applicable receipts shall exclude:

(i) revenues attributable to the sale and/or license of equipment and/or technology, including bandwidth, including but not limited to sales of devices that receive or perform the licensee's digital phonorecord deliveries and any taxes, shipping and handling fees therefore;

(ii) royalties paid to the licensee for intellectual property rights;

(iii) sales and use taxes, shipping and handling, credit card and fulfillment service fees paid to third parties;

(iv) bad debt expense; and

(v) advertising revenues other than those set forth in paragraph (a)(1)(ii) of this section.

(b) *Digital phonorecord delivery* means a digital phonorecord delivery as defined in 17 U.S.C. 115(d).

(c) *Permanent digital phonorecord delivery* means a digital phonorecord delivery that is distributed in the form of a download that may be retained and played on a permanent basis.

(d) *Licensee* means a person or entity that has obtained a compulsory license under 17 U.S.C. 115 and the implementing regulations therefore to make and distribute phonorecords, including by means of digital phonorecord delivery.

(e) *Licensee's carriers* means the persons or entities, if any, authorized by Licensee to distribute digital phonorecord deliveries to the public.

(f) *Licensed work* means the nondramatic musical work embodied or intended to be embodied in a digital phonorecord delivery made under the compulsory license.

§380.3 Royalty Rates.

(a) For a permanent digital phonorecord delivery, the royalty rate payable shall be the greater of (i) 6% of applicable receipts or (ii) 4.8 cents per track for single tracks or 3.3 cents per track for tracks sold as part of a single transaction including more than a single track ("bundles").

(b) In any case in which royalties must be allocated to specific musical works under subsection (a), each unique musical work's share shall be determined on a pro rata basis.

(c) In any future proceeding under 17 U.S.C. 115(c)(3)(C) or (D), the royalty rates payable for a compulsory license for any digital phonorecord deliveries shall be established de novo, and no precedential effect shall be given to the royalty rate payable under this paragraph for any period prior to the period as to which the royalty rates are to be established in such future proceeding.

§380.4 Scope of statutory license.

A compulsory license under 17 U.S.C. 115 extends to, and includes full payment for, all reproductions necessary to engage in activities covered by the license, including but not limited to:

(a) the making of reproductions by and for end users;

(b) all reproductions made in the normal course of engaging in such activities, including but not limited to masters, reproductions on servers, cached, network, and buffer reproductions.

CERTIFICATE OF SERVICE

I hereby certify that on this 2d day of July 2008, I caused a true and correct copy of the foregoing "Second Amended Proposed Rates and Terms of the Digital Media Association" to be served by email and overnight mail on the following:

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I further certify that on this 2d day of July 2008, I caused a true and correct copy of the foregoing "Second Amended Proposed Rates and Terms of the Digital Media Association" to be served by first class mail on the following:

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Before the
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LIBRARY OF CONGRESS
Washington, D.C.

In the Matter of Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding	Docket No. 2006-3 CRB DPRA

PROPOSED FINDINGS OF FACT OF THE DIGITAL MEDIA ASSOCIATION ("DiMA") AND ITS MEMBER COMPANIES AOL, LLC; APPLE INC.; MEDIANET DIGITAL, INC.; AND REALNETWORKS, INC.

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July 2, 2008

RESTRICTED – Subject to Protective Order
In Docket No. 2006-3 CRB DPRA

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PROPOSED FINDINGS OF FACT OF THE DIGITAL MEDIA ASSOCIATION ("DiMA") AND ITS MEMBER COMPANIES AOL, LLC; APPLE INC.; MEDIANET DIGITAL, INC.; AND REALNETWORKS, INC.

Pursuant to Section 351.14 of the rules of the Copyright Royalty Judges (the "Court"), 37 C.F.R. § 351.14, and the Court's Scheduling Order of November 20, 2007, the Digital Media Association ("DiMA"), joined by AOL, LLC; Apple Inc. (f/k/a "Apple Computer, Inc."); MediaNet Digital, Inc. (f/k/a "MusicNet, Inc."); and RealNetworks, Inc., which have each filed individual notices of participation in this proceeding, submit the following Proposed Findings of Fact in support of requested rates and terms for the compulsory license to make and distribute phonorecords by means of a digital transmission constituting a digital phonorecord delivery ("DPD") pursuant to 15 U.S.C. § 115.

INTRODUCTION

1. This proceeding presents the Court with starkly contrasting proposals leading to diametrically opposing results for the industry. DiMA's proposal – a percentage rate keyed to a practical revenue definition and backed by reasonable minima – would allow

the nascent legitimate digital distribution industry to survive and expand, even as sales of physical products continue to decline. DiMA's proposal would allow for continued digital innovation and expansion of consumer-friendly features, bringing more music to more people and providing consumers with an attractive alternative to easily accessible pirated music. It thus achieves the required statutory objectives to the benefit of consumers, copyright owners, and digital music distributors. *See infra* § X.

2. On the other hand, the Copyright Owners[1] propose dramatically higher penny rates that would severely compromise the ability of many, if not all, legal distributors to survive and expand. *See infra* § VIII(B). Given the existing penny-rate structure and the pervasive availability of illegal free music, the success of Apple's iTunes Store is an uncommon story. The Copyright Owners believe that Apple's relative success justifies an unprecedented rate hike. But in a marketplace where profitable digital music distribution is so rare, their proposal would immediately and indiscriminately raise costs across the board, making it even more difficult for legal distributors to survive and grow. This might put a few additional pennies in their pockets for every legitimate sale, but plummeting sales would soon destroy "the services that make the sales [songwriters] need to survive." DiMA Tr. Ex. 2 at 2 (Victoria Shaw, Testimony Before the Senate Judiciary Committee, April 26, 2006); *see infra* ¶¶ 251-258.

3. There is no question that the recorded music industry is in crisis. Sales of compact discs are falling precipitously, and revenues earned by songwriters, publishers, and record labels have suffered correspondingly. *See infra* ¶¶ 67-73. All agree that

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[1] The National Music Publishers' Association, Inc., the Songwriters Guild of America and the Nashville Songwriters Association International are referred to collectively as the "Copyright Owners."

piracy is the chief culprit. Today, any member of the public can obtain unlimited, unlicensed copies of every song in the world for free, on-demand, at any time of any day – without compensation to copyright owners. *See infra* § III(A)(1).

4. There is no dispute that the only solution is the successful distribution of digital music by legal distributors who attract paying customers to their innovative, user-friendly businesses. *See infra* § IV(A). By investing in enhanced technologies and service innovations – often at a net financial loss – legal distributors have lured consumers away from digital piracy and offered new opportunities to buy a wider selection of music that is unparalleled in the bricks-and-mortar retail world. *See infra* §§ III(B); IV(A), (B).

5. All of this comes at great cost to legal digital distributors. Competition from illegal pirates puts downward pressure on prices. *See infra* § III(A)(2). As a result, many digital music services struggle to survive in the marketplace, and the challenge for new entrants is even greater. *See infra* § V(B), (C). Under these economic conditions, the Copyright Owners propose to raise costs even higher, even though the future of songwriting and the music industry depends in part on the success of legal digital distribution. *See id.*

Competing Visions of the Future

6. On many key issues, the parties are in agreement. No one disputes the importance of ensuring that copyright owners receive fair compensation for the reproduction and distribution of musical works. No one disputes that piracy – the predominant economic condition affecting the marketplace – has had an enormous and harmful impact on the industry. *See infra* § III(A). And no one disputes that total legal

consumption of music has declined precipitously, even as legal consumption of digital music has begun to show promise. *See infra* § III(A)(2), (B)(2).

7. There is fundamental disagreement, however, about how to set a rate that ensures the public's complete and unfettered access to creative works, allows all industry participants to prosper fairly, and mitigates further disruption due to rampant piracy. The key is adopting rates that achieve the statutory objectives and encourage the expansion of legitimate digital distribution. The Copyright Owner's proposal would produce the opposite result by stifling new digital entry and effectively encouraging consumers to obtain pirated music for free, harming every industry participant. *See infra* § VIII(B)(1).

8. All participants in the proceeding recognize that the industry's overall revenue pie has been shrinking inexorably. *See infra* § III(A)(1). The Copyright Owners fatalistically accept that the decline will continue and inappropriately demand a larger portion of the dwindling fortunes. Their proposal thus disregards a fundamental reality that their own witnesses have recognized: While revenues from sales of physical products are falling, legal sales of digital recordings are growing and can serve as an engine for future industry growth. *See infra* § III(B)(2).

9. Setting the rate too high at this juncture would choke the evolving digital music distribution industry in its infancy. *See infra* ¶¶ 136-137. It would effectively cede digital distribution – the industry's spark of hope – to Internet pirates. *See infra* § V(D). That result, of course, would drastically reduce the public's consumption of legally licensed music, slash industry-wide revenues further, and generate severe disruptions across the industry. *See id.*

10. There is agreement among all parties that digital piracy lies at the root of many of the challenges facing the music industry today, and there is agreement that the expansion of legitimate digital music sales is one of the best bulwarks against pirate activity. *See infra* §§ III(B)(2); IV(C). Reflecting these marketplace factors, DiMA has proposed rates and terms (6 percent of retail revenue, with a minimum of 4.8 cents for single tracks and 3.3 cents per track for bundles) that would achieve the statutory objectives of maximizing the availability of creative works to the public and providing fair returns in light of current economic conditions, while avoiding undue disruption and recognizing the critical importance of ongoing technological investment and innovation. *See infra* §§ VIII(A); X.

11. By contrast, the Copyright Owners' proposal – the greater of (i) 15 cents per track or (ii) 2.9 cents per minute of playing time – comes straight from the other side of the looking glass. While acknowledging the critical need to encourage greater legitimate digital distribution, they go on to inexplicably propose a drastic increase in the mechanical rates that digital distributors must pay. *See infra* §§ IV(C); VIII(B)(1). Boosting the costs of legitimate digital distribution would discourage sales and revenue for all participants in the music business. It would simply make it harder to stay in business as a legitimate operator and hinder new entry and innovative upgrades to existing services. *See infra* ¶¶ 136-137, 253-254. Moreover, the Copyright Owners' proposal does not even purport to cover all of the copies needed to deliver a song digitally; this fundamental omission renders their proposal unworkable and *per se* unreasonable. *See infra* ¶¶ 240-241.

12. The massively disruptive result of the Copyright Owners' proposal is entirely predictable. It "harms both copyright owners and users" to force legitimate distributors to price themselves out of the market. McGlade WDT ¶ 58 (DiMA Tr. Ex. 5).[2]

Achieving the Statutory Objectives

13. DiMA's second amended proposed rates and terms are reasonable and, unlike the Copyright Owners' proposal, they achieve each of the required statutory objectives. *See infra* §§ VIII (description of rate proposal). First, DiMA's second amended proposal would maximize the availability of creative works to the public. *See* 17 U.S.C. § 801(b)(1)(A); *see infra* ¶ 352. A percentage-rate structure set at 6 percent of retail revenues for permanent downloads (with reasonable minima) would encourage the expansion of digital distribution. *See infra* §§ VII(A); VIII(A). Making comprehensive digital music catalogs available to more consumers, exposing them to more varieties of music than ever before, and providing enhanced music discovery capabilities and other innovations would boost songwriter compensation. *See infra* § IV(A)(1), (B)(1), (B)(2).

14. Second, DiMA's second amended proposal would afford copyright owners a fair return for their creative works while providing a fair income to copyright users under existing economic conditions. *See* 17 U.S.C. § 801(b)(1)(B); *see infra* ¶ 353. While this statutory objective requires the Court to balance the returns of copyright owners and users, there is no reason to view it as a zero-sum analysis, as the Copyright Owners apparently do. Critically, DiMA's second amended proposal would allow

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[2] In citations, DiMA refers to its own admitted trial exhibits as "DiMA Tr. Ex.," to the RIAA's admitted trial exhibits as "RIAA Tr. Ex.," and to the Copyright Owners' admitted trial exhibits as "CO Tr. Ex."

legitimate distributors to expand legitimate sales in the face of unprecedented online music piracy – the undisputed "existing economic condition" in the marketplace. *See infra* §§ III(A); VIII(A)(1). This in turn would increase returns for all industry participants. In other words, DiMA's second amended proposal creates the prospect of "growing the revenue pie" for the entire industry – an outcome that renders moot the Copyright Owners' concern about how to apportion shrinking industry revenues. *See infra* ¶¶ 71-75, 258, The Court faces a unique opportunity to set the industry on a path toward greater prosperity for all participants, and DiMA's second amended proposal charts that course.

15. Third, DiMA's second amended proposed rates and terms reflect the relative roles of copyright owners and copyright users in the product made available to the public with respect to the six distinct considerations identified in the third statutory objective. *See* 17 U.S.C. § 801 (b)(1)(C); *see also infra* ¶ 354. DiMA's second amended proposal recognizes the investments and contributions that have been and must continue to be made to spur innovation and lure consumers away from illegal piracy. It therefore helps to expand legal sales and boost corresponding revenues throughout the industry. *See infra* §§ IV(C); V(B), (C); (VIII)(A)(1). In contrast to an out-of-date penny-rate approach (at an unprecedented and unwarranted level) that would continue to stifle innovation, *see infra* § VII(B); VIII(B), DiMA's second amended proposal recognizes the importance of all contributions to the process – creative contributions, technological contributions, capital investments, costs incurred, risks undertaken, and contributions to opening new markets for the creative expression and the consumption of musical works

made by legitimate digital distributors. *See infra* § VIII(A)(1). DiMA's percentage-rate proposal applies a naturally self-adjusting balance to reflect all of those considerations.

16. Fourth, DiMA's second amended proposal would minimize disruption to the structure of the industry and prevailing industry practices. *See* 17 U.S.C. § 801(b)(1)(D); *also infra* ¶ 355. Unlike the percentage rates proposed by DiMA, the Copyright Owners' higher penny rate for digital music would devastate digital music distributors who need pricing flexibility to gain a toehold in the marketplace. *See infra* §§ VII(B); VIII(B)(1). On the other hand, DiMA's reasonable percentage rate and minima would not be disruptive. Music publishers use percentage rates in markets around the world already, and the Copyright Owners themselves have acknowledged expressly that a percentage structure makes the most sense for evolving businesses like digital music distribution. *See infra* § VII(A)(1), (4), (5).

17. In addition, DiMA's second amended proposed terms are reasonable and appropriate for the new digital marketplace. DiMA's second amended proposal ensures that the license covers all copies necessary to provide licensed DPDs to the public. *See infra* § VIII(A)(3). DiMA's revenue definition is easy to understand, supported by marketplace practices, and minimally disruptive to implement. *See infra* § VIII(A)(2).

* * * * *

18. This proceeding does not have to end with winners and losers. At this turning point for the industry, the Court should exercise its responsibility to ensure digital revenues grow to the benefit of all industry participants. The key to achieving the statutory objectives is setting rates that enable greater legitimate growth in the single

industry sector that has a chance to thrive. DiMA's proposal would facilitate that goal. The Copyright Owners' proposal would snuff out that opportunity at its inception.

I. THE PROCEEDING AND THE PARTIES

19. On the surface, this proceeding can be viewed as merely the latest round of rate-setting processes that began when Congress established the compulsory mechanical license more than 100 years ago. But the record reveals how this iteration differs fundamentally from all that came before it. The difference stems from technological innovation – specifically the emergence of digital technologies for storing, distributing, and listening to music – that has transformed the music industry nearly beyond recognition. *See infra* § III.

A. Procedural Background

20. This is a rate determination proceeding convened pursuant to Section 803(b) of the Copyright Act and Part 351 of the Copyright Royalty Board's rules for the purpose of making a determination under Section 115 of the Copyright Act. *See* 17 U.S.C. §§ 115, 803(b); 37 C.F.R. Part 351. The rates and terms set in this proceeding will apply for a period of five years, *see* 37 C.F.R. § 255.7, taking effect on the first day of the second month after publication of the final determination in the Federal Register. *See* 17 U.S.C. § 803(d)(2)(B). The rates and terms will apply retroactively only for those services for which none had previously been set. *See id.*

21. A notice announcing the commencement of proceeding and inviting petitions to participate was published in the Federal Register on January 9, 2006. *See* Adjustment or Determination of Compulsory License Rates for Making and Distributing Phonorecords, 71 Fed. Reg. 1454 (Jan. 9, 2006). The following entities filed petitions to participate in response to the notice: Apple Computer, Inc.; America Online, Inc.;

Copyright Owners (representing the National Music Publishers' Association, Inc, the Songwriters Guild of America, and the Nashville Songwriters Association International); DiMA; MTV Networks, Inc.; MusicNet, Inc.; Napster, LLC; RealNetworks, Inc.; Recording Industry Association of America, Inc.; Royalty Logic, Inc.; the Songwriters Guild of America; Sony Connect, Inc.; and Yahoo!, Inc.

22. On September 14, 2006, the Court referred to the Register of Copyrights a novel question of substantive law regarding the application of the Section 115 compulsory license to ringtones. *See* Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding, Memorandum Order, 71 Fed. Reg. 64,303 (Nov. 1, 2006). The Register concluded that, with certain caveats, the statutory license applies to ringtones. *See id.*

23. Hearings in this matter commenced with the parties' opening statements on January 28, 2008. Direct testimony was taken from January 28 - February 26, 2008, and rebuttal testimony from May 6 - 21, 2008.

24. On May 15, 2008, the parties informed the Court that they have reached a settlement with respect to limited downloads and interactive streaming, including all known incidental DPDs. *See Joint Motion to Adopt Procedures for Submission of Partial Settlement*, Docket No. 2006-3 CRB DPRA (filed May 15, 2008); *see also* 37 C.F.R. § 351.2(b)(2) (settlement filing and adoption rules); 17 U.S.C. § 801(b)(7)(A) (same).

25. Closing arguments are scheduled for July 24, 2008. *See Scheduling Order*, Docket No. 2006-3 CRB DPRA (Nov. 20, 2007).

26. The Copyright Act requires the Court to issue its determination not later than eleven months after the conclusion of the 21-day settlement conference period

scheduled pursuant to 17 U.S.C. § 803(b)(6)(C)(x), which in this proceeding results in a deadline of October 2, 2008. *See* 17 U.S.C. § 803(c)(1).

B. The Parties

27. Three separate coalitions have participated in this proceeding, although as explained in greater detail below, they are by no means the only entities whose interests the Court should consider, as they are not the only entities to whom the Court's determination will apply.

28. First, written direct and rebuttal testimony was presented by DiMA, joined by its member companies AOL, LLC, Apple Inc. (f/k/a Apple Computer, Inc.), MediaNet Digital, Inc. (f/k/a MusicNet, Inc.), and RealNetworks, Inc., each of which filed individual notices of participation.[3] DiMA is the national trade organization devoted primarily to the online audio and video industries, and more generally to commercially innovative digital media opportunities.

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[3] *See Notice of Intent to Participate in 2006 CRB Rate Adjustment Proceeding (Docket No. 2006-3 CRB DPRA) of Digital Media Association (on behalf of its member companies)* (filed Feb. 8, 2006); *Notice of Intent to Participate in 2006 CRB Rate Adjustment Proceeding (Docket No. 2006-3 CRB DPRA) of America Online, Inc.* (filed Feb. 8, 2006); *Notice of Intent to Participate in 2006 CRB Rate Adjustment Proceeding (Docket No. 2006-3 CRB DPRA) of Apple Computer, Inc.* (filed Feb. 8, 2006); *Notice of Intent to Participate in 2006 CRB Rate Adjustment Proceeding (Docket No. 2006-3 CRB DPRA) of MusicNet, Inc.* (filed Feb. 8, 2006); *Notice of Intent to Participate in 2006 CRB Rate Adjustment Proceeding (Docket No. 2006-3 CRB DPRA) of RealNetworks, Inc.* (filed Feb. 8, 2006). Napster, LLC and Yahoo!, Inc., which each filed individual notices of participation and joined DiMA's Written Direct Testimony, subsequently withdrew from the proceeding. *See Notice of Intent to Participate in 2006 CRB Rate Adjustment Proceeding (Docket No. 2006-3 CRB DPRA) of Napster, LLC* (filed Feb. 8, 2006); *Notice of Intent to Participate in 2006 CRB Rate Adjustment Proceeding (Docket No. 2006-3 CRB DPRA) of Yahoo!, Inc.* (filed Feb. 8, 2006); *Notice of Withdrawal of Petition to Participate (Yahoo! Inc.)*, Docket No. 2006-3 CRB DPRA (filed Aug. 24, 2007); *Notice of Withdrawal of Napster*, Docket No. 2006-3 CRB DPRA (filed Oct. 19, 2007).

29. DiMA presented testimony from the following witnesses:

- Eddy Cue, Vice President of iTunes, testified during the direct phase of the hearings. Mr. Cue testified about the iTunes Store and the benefits it offers to consumers, Apple's experience launching iTunes, and the competition digital distributors face.

- Alan McGlade, President and CEO of MediaNet Digital, testified in the direct phase of the hearings. Mr. McGlade testified about the digital distribution business.

- Margaret Guerin-Calvert, Vice Chairman of Compass Lexecon and Senior Managing Director at FTI, testified in both the direct and rebuttal phases of the hearings. Ms. Guerin-Calvert testified about the economics of digital music distribution and how best to achieve the statutory objectives in light of existing economic conditions.

- Timothy Quirk, Vice President of Music Programming for RealNetworks, and a professional songwriter and musician, testified in the direct phase of the hearings. Mr. Quirk testified about the digital distribution business.

- Dan Sheeran, Senior Vice President of Business Development at RealNetworks, testified in the rebuttal phase of the hearings about the disruptive impact of the Copyright Owners' proposed rates and terms.

- Alexander Kirk, General Manager of Product Management at RealNetworks, testified in the rebuttal phase of the hearings. Mr. Kirk testified about certain technological aspects of digital distribution.

30. Second, direct and rebuttal testimony was presented by the Recording Industry Association of America ("RIAA") – the trade association that represents the U.S. recording industry. *See Petition to Participate of the Recording Industry Association of America, Inc.*, Docket No. 2006-3 CRB DPRA (filed Feb. 8, 2006). The RIAA presented testimony from the following witnesses:

- Geoffrey Taylor, General Counsel and Executive Vice President of IFPI, testified during the direct phase of the hearings.

- Richard Boulton, an economist and director at LECG Ltd., testified during the direct phase of the hearings.

- Linda McLaughlin, an economist, testified during the direct phase of the hearings.

- Colin Finkelstein, Chief Financial Officer of EMI Music North America, testified during the direct phase of the hearings.

- Andrea Finkelstein, Senior Vice President of Business Operations and Administration at SONY BMG, testified during the direct and rebuttal phases.

- Michael Kushner, Senior Vice President of Business and Legal Affairs at Atlantic Records Group, testified during the direct phase.

- Jerold L. Rosen, Senior Vice President and General Manager for U.S. Digital Business at SONY BMG, testified during the direct phase.

- David Teece, Professor at the Haas School of Business at the University of California at Berkeley and Director and Chairman of LECG, LLC, testified during the direct phase of the hearings.

- Victoria Bassetti, Senior Vice President of Industry & Government Affairs and Vice President of Anti-Piracy, North America, for EMI Music, testified during the direct phase.

- Ron Wilcox, former Executive Vice President and Chief Business and Legal Affairs Officer of SONY BMG, testified during the direct phase.

- David Hughes, Senior Vice President of Technology at RIAA, testified during the direct phase of the hearings.

- Glen Barros, President and CEO of Concord Music Group, testified during the direct phase.

- David Munns, who was Vice Chairman of EMI Music and Chairman and CEO of EMI Music North America at the time he prepared his written testimony, testified during the direct phase of the hearings.

- David Alfaro, Managing Director in the FTI Technology Practice, testified during the rebuttal phase.

- Terri Santisi, President of T. Media Services, International, testified during the rebuttal phase.

- Scott Pascucci, President of Rhino Entertainment Company, testified during the rebuttal phase of the hearings.

- Daniel Slottje, Professor of Economics at Southern Methodist University, testified during the rebuttal phase.

- Bruce Benson, Senior Managing Director for Entertainment and Media at FTI Consulting, testified during the rebuttal phase.

- Steven Wildman, Professor of Telecommunications and Co-Director for the Quello Center for Telecommunications Management and Law, testified during the rebuttal phase of the hearings.

- Mark Eisenberg, Executive Vice President for Business and Legal Affairs in the Global Digital Business Group at SONY BMG, testified in the rebuttal phase.

- Robert Emmer, CEO of Shout! Factory, testified during the rebuttal phase of the hearings.

31. Third, direct and rebuttal testimony was presented by the National Music Publishers' Association, Inc. ("NMPA"), the Songwriters Guild of America ("SGA"), and the Nashville Songwriters Association International ("NSAI") (collectively, the "Copyright Owners"), which are trade associations that represent music publishers and songwriters in the United States. *See Petition to Participate of National Music Publishers' Association, Inc., The Songwriters Guild of America and Nashville Songwriters Association International*, Docket No. 2006-3 CRB DPRA (filed Feb. 8, 2006); *Petition to Participate of The Songwriters Guild of America*, Docket No. 2006-3 CRB DPRA (filed Feb. 7, 2006). The Copyright Owners presented testimony from the following witnesses:

- Rick Carnes, a songwriter and President of the Songwriters Guild of America, testified during the direct phase of the hearings.

- Steve Bogard, a songwriter and President of the Nashville Songwriters Association of America testified during the direct phase.

- Roger Faxon, President and CEO of EMI Music Publishing, testified during the direct and rebuttal phases.

- Phil Galdston, a songwriter, testified during the direct phase of the hearings.
- Victoria Shaw, a songwriter, testified during the direct phase.
- Maia Sharp, a songwriter, testified during the direct phase.
- Stephen Paulus, a songwriter, testified during the direct phase.
- Irwin Robinson, Chairman and CEO of Famous Music, Inc., a music publishing company, testified during the direct phase of the hearings.
- Claire Enders, CEO of Enders Analysis, testified during the direct phase of the hearings.
- David Israelite, President and CEO of the National Music Publishers Association, testified during the direct phase.
- Ralph Peer, Chairman and CEO of Peermusic, Inc., a music publishing company, testified during the direct phase of the hearings.
- Helen Murphy, President of International Media Services, Inc., testified during the direct phase.
- William Landes, Professor of Law and Economics at the University of Chicago Law School, testified in both the direct and rebuttal phases of the hearings.
- Nicholas Firth, who at the time of his written testimony was the Chairman and CEO of BMG Music Publishing, testified in the direct phase of the hearings.
- Jeremy Fabinyi, Managing Director of Mechanicals at the Mechanical Copyright Protection Society-Performing Rights Society Alliance in the United Kingdom, testified in the rebuttal phase of the hearings.
- Kevin Murphy, Professor of Economics at the University of Chicago, testified in the rebuttal phase.
- Alfred Pedecine, the Harry Fox Agency's Chief Financial Officer, testified in the rebuttal phase.
- Ketan Mayer-Patel, Professor of Computer Science at the University of North Carolina, Chapel Hill, testified during the rebuttal phase.
- Judith Finell, President of Judith Finell MusicServices, Inc., testified in the rebuttal phase of the hearings.

* * * * *

32. While these three coalitions are the only parties that have participated in the proceeding, the Court's final determination will apply to many others going forward. *See* 17 U.S.C. § 115(a)(1) (any person may obtain a compulsory license); a*ccord* Guerin-Calvert WDT ¶ 21 (DiMA Tr. Ex. 7) ("[T]he rate methodology . . . must have sufficient flexibility and scope to address [future] developments and incentives . . . . Crafting the appropriate structure and methodology for rates from an economic perspective entails recognition of the fact that in developing industries and technologies with a variety of business models and strategies, the methodology must be such so as not to favor particular technologies nor substantially disadvantage others."); Guerin-Calvert WRT ¶ 4 (DiMA Tr. Ex. 10). Unlike proceedings where the universe of licensees is limited, *see, e.g., Determination of Rates and Terms for Preexisting Subscription Services and Satellite Digital Audio Radio Services*, 73 Fed. Reg. 4080, 4094 (Jan. 24, 2008), the beneficiaries of the Section 115 compulsory mechanical license are impossible to ascertain in advance.

33. Many potential digital music licensees – including Apple, RealNetworks, MediaNet, and Napster – participated in this proceeding. Many others – such as Amazon.com, Wal-Mart and eMusic – did not. Countless other potential participants are unknown, as entry and exit continue to take place alongside continued technological innovation. In this regard, Margaret Guerin-Calvert – DiMA's expert in economics, industrial organization and the economics of regulated industries, *see* 2/25/08 Tr. 4439:1-10 (Guerin-Calvert) (proffer and acceptance) – testified that in her opinion the forward-looking objectives of Section 801(b) are best achieved when rates

> allow for and encourage, not deter new entry or expansion of models beyond those seen today – that is, rates [that] . . . foster continued innovation and evolution of the marketplace, not 'lock' in place existing marketplace structure and conditions (participants, pricing, etc.) . . . . Analysis of existing industry participants, whatever their level of success or competitive vulnerability, . . . confirms the dynamic nature of the marketplace and shows that from an economic perspective the forward looking statutory objectives requires rates that allow for the continued evolution of the marketplace, including new entry, new methods of distributing musical works so as to maximize the distribution of musical works to the benefit of copyright owners, users, and the ultimate consumer.

Guerin-Calvert WRT ¶ 8 (DiMA Tr. Ex. 10); *see id.* ¶ 4.

II. THE SUBJECT MATTER OF THE COURT'S FINAL DETERMINATION

34. Pursuant to Section 115(c), the Court is charged with determining the reasonable rates and terms of royalty payments for compulsory licenses for mechanical rights for all phonorecord deliveries, including digital phonorecord deliveries.

35. As noted above, *see supra* ¶ 24, the parties informed the Court on May 15, 2008, that they have reached a settlement with respect to limited downloads and interactive streaming, including all known incidental digital phonorecord deliveries. *See Joint Motion to Adopt Procedures for Submission of Partial Settlement*, Docket No. 2006-3 CRB DPRA (filed May 15, 2008). In response, the Court indicated that the parties are authorized to settle, or settle in part, at any time, and granted the parties' joint motion for relief from the obligation to submit briefing related to the settled issues. *See Order (Joint Motion to Adopt Procedures for Submission of Partial Settlement)* at 1, Docket No. 2006-3 CRB DPRA (May 27, 2008). As a result of the parties' partial settlement and the Court's Order, the parties have agreed to limit their proposed findings of fact and proposed conclusions of law to rates and terms that have not been settled.

36. Accordingly, DiMA proposes rates and terms for permanent downloads. A permanent download – also referred to as a "permanent digital phonorecord delivery" – is a digital phonorecord delivery distributed in the form of a download that may be retained and played on a permanent basis. *See, e.g., Second Amended Proposed Rates and Terms of the Digital Media Association*, Ex. A, § 380.2(c), Docket No. 2006-3 CRB DPRA (filed July 2, 2008) (hereinafter "DiMA Second Amended Proposal") (copy attached hereto as Appendix A).

III. TECHNOLOGY HAS REVOLUTIONIZED THE RECORDED MUSIC INDUSTRY

37. It is nearly impossible to overstate the transformative impact that recent technological changes have had on the production, delivery, and consumption of all forms of media. In particular, technological advances related to digitization, the Internet, and systems for transmitting packets of digital information have, in the span of just a few years, radically altered the entire music industry. *See, e.g.,* CO Tr. Ex. 142 at DIMA_2006-3_CRB_DPRA045004 (RealNetworks 2006 Annual Report) ("Access to the Internet through devices other than a personal computer (PC), such as personal digital assistants, cellular phones, television set-top devices, game consoles, Internet appliances and portable music and games devices has increased dramatically and is expected to continue to increase."); CO Tr. Ex. 21 at 3 (Warner Music Group, 2005 Annual Report) (describing rapid growth of digital playback devices); CO Tr. Ex. 15, attach. 704 at RIAA0092941, RIAA0002955 (EMI Operating Board Presentation, May 16, 2005) (describing the proliferation of media formats available for consumption). Above all, these changes have made it possible to deliver perfect copies of virtually every piece of music to millions of people instantly. *See, e.g.,* CO Tr. Ex. 45 at RIAA0043147 (EMI

Group, 2005 Annual Report) ("The digital revolution has dramatically changed how consumers can access and buy music.").

38. This technological tidal wave has also created other types of media (multiple digital TV channels, DVDs, video games, Internet, Instant Messaging), which compete for the limited free time and money that could be spent on recorded music. *See, e.g.,* CO Tr. Ex. 142 at DIMA_2006-3_CRB_DPRA044987-90, DIMA_2006-3_CRB_DPRA045004 (RealNetworks 2006 Annual Report) (describing the varied applications – including games, video, and audio – resulting from recent technological advances); CO Tr. Ex. 21 at 15 (Warner Music Group, 2005 Annual Report) (describing competition to recorded music from new forms of digital entertainment).

39. Recent technological innovations also make it possible for many more people to acquire and consume music, both legally and illegally. Indeed, while technological transformation (and especially the consumer-friendly features developed by legitimate digital distributors) holds great potential for the music industry, Internet-based piracy poses an unparalleled threat. The fact that the legitimate, royalty-paying music business must exist side-by-side with a vast, uncontrolled and non-royalty-paying pirate marketplace presents extraordinary burdens on the entire music business.

A. Digital Music Piracy Is the Most Pressing Economic Condition Facing the Music Industry

40. As every party to this proceeding has proclaimed in no uncertain terms, digital piracy poses a singularly disruptive threat to all legitimate industry participants and, ultimately, to the ability of consumers to obtain recorded music legally. *See, e.g.,* Guerin-Calvert WDT ¶ 30 (DiMA Tr. Ex. 7) ("The development of the industry has been hampered by the substantial issues associated with piracy and the fact that non-royalty

bearing music is widely available."). "Piracy, both personal and commercial, has exploded with the increasing availability and decreasing cost of tools that facilitate copyright infringement on a massive scale." CO Tr. Ex. 15, attach. 707 at RIAA0018181 (Universal Music Group Presentation, 2004). Establishing appropriate rates and terms for the compulsory mechanical license is critical to mitigating piracy's disruptive impact and ensuring the maximum legitimate availability of creative works to the public. *See, e.g.*, McGlade WDT ¶ 58 (DiMA Tr. Ex. 5), Quirk WDT ¶¶ 6, 46 (DiMA Tr. Ex. 8).

41. As the defining economic condition in the recorded music industry today, the impact of piracy on industry participants cannot be avoided in determining rates in this proceeding. *See* 17 U.S.C. § 801(b)(1)(B) (providing that terms and rates shall be calculated "[t]o afford the copyright owner a fair return for his or her creative work and the copyright user a fair income under existing economic conditions") (emphasis supplied). Indeed, the growing prevalence of piracy threatens the legal availability of creative works to the public; dims the prospect that the copyright owners can receive a fair return and the copyright licensees a fair income; and requires massive contributions and investments by digital music distributors seeking to launch in an entirely new marketplace. *See id.* § 801(b)(1)(A)-(C). The perpetuation of the penny rate, at an unprecedented level, will be massively disruptive. *See id.* § 801(b)(1)(D).

1. Piracy Threatens All Legitimate Participants

42. As all parties agree, the explosive growth in easily available illegal content jeopardizes the music industry. According to one estimate, 20 billion tracks were downloaded illegally in 2006. *See* CO Tr. Ex. 29 at CO9008765 (IFPI Recording Industry in Numbers 2007). Roger Faxon, the Chairman and CEO of EMI Music Publishing, testified that "the value of pirated music worldwide is $5 billion, and the

number of tracks available for illegal download is 1 billion. For every track sold legitimately there are six tracks taken illegally." Faxon WDT ¶ 45 (CO Tr. Ex. 3); *see also* Israelite WDT ¶¶ 26-27 (CO Tr. Ex. 11) (attributing the "steep slide in the sale of CDs and other physical product" in part to piracy).

43. Victoria Bassetti, EMI Music's Senior Vice President of Industry & Government Affairs and Vice President of Anti-Piracy for North America, testified that "for every one song that is legally purchased, approximately five to seven are illegally downloaded or downloaded without compensating the creators." 2/19/08 Tr. 3865:12-15 (Bassetti); *see also* Bassetti WDT at 3-6 (RIAA Tr. Ex. 68). Statistical data presented by the Copyright Owners confirm the scope of the problem. *See* Enders WDT at 10 (CO Tr. Ex. 10) (1.1 billion music files were available for illegal consumption in 2003); CO Tr. Ex. 15, attach. 707 at RIAA0018180 (Universal Music Group Presentation, 2004) (98% of all music downloads are illegal; just 2% are legitimate sales that result in compensation to distributors, labels, publishers, and songwriters).

44. Steve Bogard, a successful songwriter and the current president of the Nashville Songwriters Association International, explained that "peer-to-peer systems and the rapid increase in music piracy" have caused his "mechanical royalty stream [to] drop[] significantly." Bogard WDT ¶ 17 (CO Tr. Ex. 2). Mr. Bogard presented the Court with a detailed description of the direct impact that piracy has had on him personally: On the same day that one of his songs was first released by a popular country group, "there were already 1,100 [pirate] sites offering to 'share it' for free." *Id.* Mr. Bogard further observed that "neither songwriters nor music publishers get paid for the millions of illegal downloads and pirated copies of our music that we are still fighting to stop." *Id.*

¶ 22; *see also* Galdston WDT ¶ 16 (CO Tr. Ex. 4) ("Once I have lost a royalty, due to an unauthorized download of one of my songs, I have no way to recoup it.").

45. Executives from the music publishing industry also testified that the emergence and growth of piracy have had a profoundly negative impact on their businesses. David Israelite, President and Chief Executive Officer of NMPA, testified that "rampant music piracy" has contributed to the decline in sales of physical products. Israelite WDT ¶ 27 (CO Tr. Ex. 11). "Sales slumped as music listeners chose to download music for free rather than purchase it in stores. That dramatically undercut the mechanical royalty stream, which, at bottom, is premised on a payment for every copy of a recording of a song that is distributed to the public." *Id.*; *see also* Robinson WDT ¶ 17 (CO Tr. Ex. 8); CO Tr. Ex. 21 at 15 (Warner Music Group 2005 Annual Report) ("In recent years, due to the growth in piracy, we have been forced to compete with illegal channels such as unauthorized Internet peer-to-peer file-sharing and downloading and industrial duplication."); CO Tr. Ex. 15, attach. 700 at RIAA0018083 (Universal Music Group Presentation, 2006) ("[P]iracy . . . looms as a major challenge to our business and industry as a whole.").[4]

46. As a result of piracy, consumers have grown accustomed to getting music for free. *See* Guerin-Calvert WDT ¶ 40 (DiMA Tr. Ex. 7) ("One of the biggest challenges for legitimate digital music service providers is to convince consumers, particularly those in the high school and college age demographic group used to

[4] DiMA has designated Protected Material via shading in the restricted version of this document and marked the affected pages with the label required by the Court's *Protective Order*. *See Protective Order* ¶ 10(a), Docket No. 2006-3 CRB DPRA (March 3, 2007). It has redacted all such material from the public version. *See id.* The sworn statement, Rule 11 Certification, and Redaction Log required by the *Protective Order* are attached at the end of this filing. *See id.* ¶ 10(b).

consuming music for free or from illegal file-sharing, to pay for music through legitimate services."); *see also* CO Tr. Ex. 15, attach. 700 at RIAA0018084 (Universal Music Group Presentation, 2006). Changing the consumer perception that music is free is a critical challenge for the industry.

47. The threat to digital music distributors, including each of DiMA's member companies, is particularly acute, as "illegal music . . . is [their] most formidable competitive rival." Cue WDT ¶ 33 (DiMA Tr. Ex. 3). Indeed, "[t]he huge market for pirated digital music is the single biggest challenge faced by legitimate [digital distribution] services." Quirk WDT ¶ 44 (DiMA Tr. Ex. 8). Piracy forces "fledgling business[es]" and other legal digital distributors to "compete in a marketplace in which our fundamental competition is the widespread availability of free product to consumers." McGlade WDT ¶ 51 (DiMA Tr. Ex. 5). As DiMA member RealNetworks reported in its 10-K filing for the 2006 fiscal year:

> Our online music services . . . face significant competition from "free" peer-to-peer services which allow consumers to directly access an expansive array of free content without securing licenses from content providers. Enforcement efforts have not effectively shut down these services and there can be no assurances that these services will ever be shut down. The ongoing presence of these "free" services substantially impairs the marketability of legitimate services like ours.

CO Tr. Ex. 142 at DIMA_2006-3_CRB_DPRA044998 (RealNetworks 2006 Annual Report).

2. Piracy Raises Costs for Legitimate Distributors and Puts Downward Pressure on the Prices They Can Charge

48. Piracy has a double-barreled impact on legitimate digital distributors, simultaneously raising costs and limiting prices. On the cost side, the prevalence of piracy requires legitimate digital distributors to spend substantial sums to develop and

publicize new and innovative features that distinguish their products from those offered by illegal services.[5] Launched in the midst of massive online piracy, iTunes proved that "the right offer, supported by marketing, could succeed." CO Tr. Ex. 15, attach. 700 at RIAA0018077 (Universal Music Group Presentation, 2006); *see also* Guerin-Calvert WDT ¶ 54 (DiMA Tr. Ex. 7) ("Digital music stores must continually invest in enhancing the digital music experience to entice the consumer to come back to the store, because tracks they offer are available for free on pirate P2P sites."). "With non-royalty bearing music available through illegal file-sharing, consumers must determine that there is value in paying to consume music through legitimate providers." Guerin-Calvert WDT ¶ 89 (DiMA Tr. Ex. 7); *see also id.* ¶ 102; Guerin-Calvert WRT ¶ 7 (DiMA Tr. Ex. 10) ("Digital distributors must invest in innovative products to the user that distinguish their products from the musical works available from non-legitimate sources.").

49. As RealNetworks explained in its 2006 annual report, "developing new, and enhancing existing, products and services is complex, costly and uncertain," but it is also necessary under existing economic conditions, namely piracy. CO Tr. Ex. 142 at DIMA_2006-3_CRB_DPRA045002 (RealNetworks 2006 Annual Report). Failure to "develop and introduce new products and services that achieve market acceptance could result in a loss of market opportunities." *Id.*; *see also* Guerin-Calvert WDT ¶ 40 (DiMA Tr. Ex. 7) ("Legitimate digital music service providers must distinguish their services [from pirate services] via value-added content and ease of use.").

50. Legal digital distributors must also bear the cost of ensuring that they employ the security features necessary "to stay one step ahead of the online pirates." Cue

[5] Digital distributors' costs of operations and investments in technology are described in greater detail below. *See infra* § V(B).

WDT ¶ 46 (DiMA Tr. Ex. 3). Since its launch, the iTunes Store, for instance, "ha[s] been through numerous systems upgrades or versions not only in order to improve the experience for the end user but also to maintain the effectiveness of the Fairplay DRM, which has been (and continues to be) the subject of hacking attempts." *Id.* These "continued investments are protecting the rights holders' interests, but at a significant cost to iTunes." *Id.*

51. In addition to higher innovation and security costs, piracy also necessitates higher marketing costs. Since legitimate digital music distributors can survive only if they separate themselves from illegal services that provide musical works for free, legitimate digital distributors are forced to invest heavily in educating consumers about the availability and consumer-friendly benefits of legitimate digital distribution services. *See infra* § V(B)(6); *see also* Cue WDT ¶¶ 47, 48 (DiMA Tr. Ex. 3); McGlade WDT ¶ 54 (DiMA Tr. Ex. 5).

52. Piracy also forces legitimate digital distributors to price as low as possible so as to compete with free music. Alan McGlade, MediaNet's President and Chief Executive Officer, explained the downward pricing pressure as follows:

> [W]e will continue to compete against free music in an environment where broadband access and technology make it easier and easier for consumers to bypass the market and find what they want to play and share with each other without paying for it.

McGlade WDT ¶ 54 (DiMA Tr. Ex. 5). Timothy Quirk, RealNetworks' Vice President of Music Programming, testified that digital distribution is "a new business, it's the early days of this new business, and we are competing with music for free." 2/26/08 Tr. 4618:11-14 (Quirk). He explained that failing to slash prices for digital distribution means ceding market share to pirates because "it is very difficult for us to wean people

off of piracy, off of music for free if the price point is too high." *Id.* 4618:14-17 (Quirk); *see also* Sheeran WRT ¶ 11 (DiMA Tr. Ex. 11) ("[T]he easy availability of illegal downloads places a cap on what many consumers are willing to pay.").

53. Eddy Cue, Apple's Vice President of iTunes, described this constraint in similar terms, noting that finding the right price point "was one of the key tenets" under consideration when Apple launched the iTunes Music Store. 2/25/08 Tr. 4243:3 (Cue). "When you're trying to compete with free," Mr. Cue testified, "any price obviously is going to be greater [than free]. So we felt that had to have an offering that a consumer would look at and feel that it's reasonable and fair." *Id.* 4243:3-11 (Cue).

54. In his written testimony, Mr. Cue detailed the intense price pressures imposed by illegal digital distribution:

> [P]iracy has been a key factor in determining our price point in the U.S. and other markets around the world. It may be stating the obvious, but as we are competing with a product that is free, we need to pick a price that balances that reality against the quality of our product and our variable costs for distributing that product, which affords [the iTunes Store ("iTS")] the opportunity to earn a profit. We believe that a large measure of our success is attributable to the fact that we price songs for less than a dollar, a price point that diminishes the financial "rewards" of pirating "free" music. And we believe that if the price of our songs were to increase, many people would switch back to piracy. From my perspective and experience, the $0.99 per-track retail price represents the price point that maximizes overall revenues from iTS for all industry stake-holders. If we had to raise that price, I believe total sales transactions and aggregate revenues would fall precipitously.

Cue WDT ¶ 38 (DiMA Tr. Ex. 3) (emphasis supplied).

55. Ms. Guerin-Calvert explained the importance of this pricing phenomenon. "The widespread availability of [illegal] downloads reduces the revenues available for digital (and other sales)," she testified. Guerin-Calvert WDT ¶ 30 (DiMA Tr. Ex. 7). This "means that digital media companies need to keep prices at very attractive levels to

attract consumers." *Id.*; *see also id.* ¶ 40 ("[I]llegal file-sharing constrains the price that legitimate digital music services can charge customers."); *see also* Teece WDT at 35 (RIAA Tr. Ex. 64) (describing price competition from pirated music).

56. The pricing pressure resulting from piracy has widespread ramifications for the recorded music industry. Ron Wilcox, Executive Vice President and Chief Business and Legal Affairs Officer for Sony BMG Entertainment, noted that labels face the "fundamental proposition" of "having to compete with free," which generates significant pricing pressure on digital products and physical products. 2/20/08 Tr. 3949:21-3950:4 (Wilcox). Victoria Bassetti of EMI Music agreed that "competing with free is a very difficult thing to do." 2/19/08 Tr. 3866:4-9 (Bassetti). As a result, the record labels are beginning to recognize the importance of reducing their prices to distributors in the face of this inexorable downward price pressure. *Id.* 3866:13-16 (Bassetti) (prices have to become more "sensitive to . . . the wide-scale availability" of pirated music).

57. The Copyright Owners' witnesses also recognized that digital distributors' pricing decisions reflect "a marketplace whereby the competition was against illegal or illegitimate downloads" and that digital distributors therefore need to establish prices that can "compete with free." 2/6/08 Tr. 1969:10-15 (H. Murphy). Victoria Shaw, a songwriter who has testified before Congress on the importance of encouraging legitimate digital sales to counteract piracy, *see* DiMA Tr. Ex. 2 (Shaw Testimony Before the Senate Judiciary Committee, April 26, 2006), agreed that legitimate digital distributors have a hard time competing against pirate services. She noted that the temptation to download a pirated song "because it's free" places tight competitive

restraints on digital distributors. 1/30/08 Tr. 850:14-851:18 (Shaw). Likewise, Irwin Robinson – Chairman of NMPA's Board of Directors, and Chairman and CEO of The Famous Music Publishing Companies – acknowledged that digital phonorecord deliveries must compete with free pirated music. *See* 1/31/08 Tr. 1094:17-1095:2 (Robinson).

58. Indeed, both of the Copyright Owners' economic experts concurred that piracy pushes prices down. Dr. William Landes testified that piracy leads to lower demand for legitimate products which, in turn, places downward pressure on price. *See* 2/11/08 Tr. 2465:16-18 (Landes). Dr. Kevin Murphy explained that introducing free pirated versions of a product into the marketplace reduces the price that distributors can charge for legitimate versions of the product. *See* 5/19/08 Tr. 7018:6-9 (K. Murphy). Moreover, in an article describing the impact of piracy, Dr. Murphy joined two other scholars in explaining that prices drop precipitously as a function of the number of illegal copies generated. *See* RIAA Tr. Ex. 93 at 206-07 (Klein, Lerner & Murphy, Intellectual Property: Do We Need It?, AEA Papers and Proceedings, May 2002); *see also* Guerin-Calvert WDT ¶ 39 & n.27 (DiMA Tr. Ex. 7) (citing Dr. Murphy's paper for the proposition that "[p]iracy ultimately affects the quantity of legitimate digital sales, creates cost pressure, and acts as a constraint on the ability to price digital music").

59. Raising mechanical rates or imposing de facto retail price regulation via unreasonable penny minimum fees would lead to even higher costs for digital distributors, making it more likely that digital distributors would be compelled to "abandon the market to Internet pirates." Quirk WDT ¶ 6 (DiMA Tr. Ex. 8). Under that massively disruptive scenario – in which higher costs would force digital distributors to curtail further investments and innovations – the public availability of legitimate creative

works would be reduced, and "both consumers and content creators would suffer." *Id.*; *see also* Guerin-Calvert WDT ¶ 112 (DiMA Tr. Ex. 7) ("To provide appropriate economic incentives, royalties should recognize the constraint on pricing that the copyright user faces to encourage legitimate use of copyrighted material."). Mr. McGlade, MediaNet's President and CEO, testified that setting the mechanical rate too high "would almost assuredly signal the end of certain business models[,] . . . severely disrupt the digital music marketplace and result in a loss of consumer confidence with respect to legal digital music services." McGlade WDT ¶ 57 (DiMA Tr. Ex. 5). This, he continued, would lead to "an increase in piracy activities." *Id.*

B. Legal Digital Distributors Attract Consumers with Constant Innovation and Improvements

60. Virtually every witness testified that technological changes and innovations – particularly in the delivery of music to consumers – have transformed the recorded music industry in recent years. While technology may have enabled an expansion of music piracy, many witnesses also recognized that technological innovation is critical to the future of the recorded music industry. *See, e.g.*, 1/30/08 Tr. 660:14-22, 661:3-11, 667:10-19 (Faxon) (digital innovation can provide powerful benefits to copyright owners). In fact, Dr. William Landes, the Copyright Owners' chief economic expert in this proceeding, agreed that technological innovation is "far more important" to maximizing copyright owner revenue in the long run than the mechanical rate. 2/11/08 Tr. 2153:5-14 (Landes) (emphasis supplied).

61. Dr. Landes explained that "different business models of music distribution should be permitted to develop and compete to provide music to consumers." Landes WDT ¶ 34 (CO Tr. Ex. 22). He voiced support for further technological innovation from

digital music distributors because "in the long run this will maximize availability of creative works to the public." *Id.* (emphasis supplied); *see also* 2/11/08 Tr. 2509:10-17 (Landes) ("[O]bviously you wouldn't have wanted to impose road blocks . . . which would have prevented the new technologies in digital delivery of music."). He agreed that from 1910 to the present, the effect of technological innovation far outweighed the effect of declining or static mechanical royalty rates. *See id.* 2509:18-2510:5 (Landes). And he agreed that innovation and new technology are the principle determinants of the growth of the recorded music industry as a whole, *see id.* 2512:22-2516:12 (Landes), and that "technological innovation in distributing copyrighted works would tend to benefit the parties who provide these works" – that is, the owners of the copyrights. *Id.* 2507:17-2508:15 (Landes).

1. Technological Advancement in the Delivery of Music Creates Great Potential for the Recorded Music Industry

62. Every party to this proceeding recognizes the immense potential of the technological metamorphosis that has swept over the music industry and the unprecedented opportunities it presents for industry participants and music consumers. *See, e.g.,* Guerin-Calvert WDT ¶ 10 (DiMA Tr. Ex. 7) ("The digital music industry represents a fundamental change in the mode of delivering music content."). The EMI Group – the parent company of both a major music publisher (EMI Music Publishing) and a major record label (EMI Music), *see, e.g.,* RIAA Tr. Ex. 7 at 12-14 (EMI Group, 2007 Annual Report) – has hailed the industry-wide "transformation" that has resulted from "new digital music formats and channels." CO Tr. Ex. 45 at RIAA0043151 (EMI Group, 2005 Annual Report). In its 2007 Annual Report, the company noted that "[d]igital technology is multiplying the ways in which we can monetise our music assets

and our key strategic priority is to continue to make music content available on all economically attractive platforms, formats and services to ensure the widest consumer reach." RIAA Tr. Ex. 7 at 18 (EMI Group, 2007 Annual Report). Reflecting the paramount role digital music may play in the future, the EMI Group's Chief Financial Officer reported in 2006 that "[d]igital is a key focus in our development." RIAA Tr. Ex. 6 at 11 (EMI Group, Preliminary results 2005/06).

63. The impact of the technological sea change drives music publishing, recording and distribution in new directions by stimulating the development of "[n]ew formats, uses, outlets and channels for our music content." CO Tr. Ex. 45 at RIAA0043147 (EMI Group, 2005 Annual Report); *see also* RIAA Tr. Ex. 7 at 18 (EMI Group, 2007 Annual Report) (describing the "significant change" in the marketplace resulting from "the rapid development of the digital music industry"). These technologies have "dramatically changed how consumers can access and buy music." CO Tr. Ex. 45 at RIAA0043147 (EMI Group, 2005 Annual Report). By "fuelling consumers' appetite for music," the digital revolution is "stimulating other new businesses," "creating exciting, new revenue opportunities," and offering the prospect of real growth for copyright owners and copyright users alike. *Id.* at RIAA0043151. As EMI Music Publishing's Chairman and CEO explained: "Consumers today can purchase music at any time of day, can put music on their computer, CD, MP3 player and phone and make digital quality copies when this is legally permitted." Faxon WDT ¶ 48 (CO Tr. Ex. 3); *see also* 1/29/08 Tr. 516:2-7 (Faxon) ("There is portability. There is the ability to manage the files, all of those things and others make it a better product, and therefore, a product that is more valuable to consumers.").

64. The 2005 Annual Report from Warner Music Group – including its major music publisher (Warner/Chappell) – voiced the same enthusiasm about the power of this technological "renaissance." CO Tr. Ex. 21 at 3 (Warner Music Group, 2005 Annual Report). The shift to digital sales and expanding modes of digital distribution, Warner reported, "offers great potential to power ever greater consumption of music," and "holds significant promise and opportunity for the industry." *Id.* at 3, 10-K attach. at 6. Highlighting the critical contributions from legal digital distributors – including DiMA's member companies – Warner explained that "new and emerging third-party digital distribution outlets . . . offer a superior customer experience relative to illegal alternatives, as they are easy to use, offer uncorrupted song files and integrate seamlessly with increasingly popular portable music players." *Id.*, 10-K attach. at 6.

2. Digital Distribution Is the Only Sector of the Recorded Music Industry in Which Sales Have the Potential to Grow

65. Even hampered by rampant piracy, digitally distributed music is the only sector of the industry in which sales have the potential to grow. Indeed, "[d]igital music companies have expanded the availability and appeal of royalty-bearing creative works in a manner that is truly revolutionary." Guerin-Calvert WDT ¶ 10 (DiMA Tr. Ex. 7); *see also* 2/4/08 Tr. 1338:8-1339:3 (Enders) (80 percent of consumers have not yet purchased digital downloads).

66. While the growth in digital sales has not yet made up for the decline in physical products, the general trend provides clear evidence that the digital sector has the best prospects for pulling the rest of industry out of its current decline. *See infra* ¶¶ 73-75. Of course, realizing the potential of digital distribution to resuscitate the industry requires a rate determination that discourages piracy's disruptions and encourages digital

distributors to continue investments in technological advances and innovation. *See infra* ¶¶ 136-137, 147-150.

67. Beginning in the late 1990s – before the widespread introduction of music downloads – music sales in the United States began plummeting. *See, e.g.,* CO Tr. Ex. 15, attach. 700 at RIAA0018073 (Universal Music Group Presentation, 2006) (the industry entered "a state of free fall."). Negative growth rates, driven by piracy, became the norm. *See, e.g.,* CO Tr. Ex. 21 at 18 (Warner Music Group, 2005 Annual Report). The downward trend for physical product sales continued, and even worsened, in the following years, with no end in sight. *See, e.g.,* RIAA Tr. Ex. 27 at CO02001066 (Enders Analysis, Recorded Music and Music Publishing, March 2007) ("[H]opes of stabilising [the] top line have been comprehensively dashed by steep declines in CD sales in most major markets.").

68. In 2000 and 2001, some industry participants began to see the potential in digital distribution. The first entities to attempt to enter the new digital marketplace were subscription services like MusicNet, which was formed as a joint venture in 2001.[6] *See* McGlade WDT ¶ 5 (DiMA Tr. Ex. 5); *see also* Enders WDT at 11 (CO Tr. Ex. 10). These early services were relatively unattractive to consumers, however, because they did not offer music from all of the major record companies. *See, e.g.,* Enders WDT at 11 & n.14 (CO Tr. Ex. 10) (describing the fate of several early subscription services); Guerin-Calvert WDT ¶ 48 n.40 (DiMA Tr. Ex. 7) (same); 2/26/08 Tr. 4754:2-21 (Munns) (testifying that failure to offer music from every label "doomed" early subscription

[6] Unlike other subscription services, which provide service directly to end user customers, MusicNet (now MediaNet) primarily offers a "wholesale infrastructure solution" through which its distributor-customers make the service available to consumers. McGlade WDT ¶ 6 (DiMA Tr. Ex. 5).

services); 2/6/08 Tr. 1975:11-1976:5 (H. Murphy) (testifying that catalog restrictions hindered development of early digital services); H. Murphy WDT ¶ 26 (CO Tr. Ex. 15) (same).

69. Digital distribution first achieved some measure of success following the 2003 launch of Apple's iTunes Store, to the acclaim of the record industry. *See* CO Tr. Ex. 15, attach. 700 at RIAA0018077 (Universal Music Group Presentation, 2006) (describing iTunes as a "Spark of Hope"). Before the iTunes Store, as Mr. Cue noted, millions of Americans were "already accustomed to obtaining music on the Internet—mostly for free and mostly without authorization from copyright holders." Cue WDT ¶ 13 (DiMA Tr. Ex. 3). Apple invested (and risked) tens of millions of dollars in developing and launching its service. *See* 2/25/08 Tr. 4224:7-11 (Cue). The result – Apple's iTunes Store – provided "the public with a lawful and user-friendly means to research, organize, sample, store, and purchase music digitally." Cue WDT ¶ 13 (DiMA Tr. Ex. 3). The Justice Department's Antitrust chief credited the iTunes Store (and the features it provides) with solving the problem of "how to create a consumer-friendly, yet legal and profitable, system for downloading music and other entertainment from the Internet." *Id.*

70. In the years since the iTunes Store came online, Apple and other digital distributors have invested many additional millions in technological enhancements and in securing access to comprehensive catalogs of music.[7] These developments have attracted paying customers and generated "meaningful digital music revenue," even in the face of

[7] The innovations and enhancements provided by DiMA members and other legal digital distributors are described in greater detail below, *see infra* § IV(A), as are their costs and investment requirements. *See infra* § V(B), (C).

further declines in physical sales. CO Tr. Ex. 15, attach. 700 at RIAA0018078 (Universal Music Group Presentation, 2006); *see also* 1/31/08 Tr. 1071:17-1072:6 (Robinson) (testifying that legitimate digital music distributors have led to a dramatic increase in the sales of digital music, which is good for music publishers).

71. In fiscal year 2005, Warner Music Group's global "physical sales of Recorded Music formats declined by approximately $124 million" compared to the year before, due to the "the continued impact of industry-wide piracy." CO Tr. Ex. 21 at 46-47 (Warner Music Group, 2005 Annual Report).[8] In the same period, however, Warner Music Group's global digital sales grew from $105 million to $137 million, due to "the development and increased consumer usage of legal, online distribution channels for the music industry." *Id.* The company's digital sales in the United States alone grew by $79 million, to $105 million. *See id.* In a 2006 presentation, Warner Music Group projected that digital revenues would continue to rise at least until 2010, yet rested this projection on the pivotal assumption that "[n]ew entrants" would "drive additional upside." CO Tr. Ex. 15, attach. 731 at RIAA0028581 (Warner Music Group Presentation, 2006) (emphasis supplied).

72. The story is the same for Universal Music Group. While the company's "physical revenue declined slightly" from 2004 to 2005, its "digital music sales grew nearly 175%." *See* CO Tr. Ex. 15, attach. 700 at RIAA0018079 (Universal Music Group Presentation, 2006). Similarly, notwithstanding the "worsening market conditions which affected the entire recorded music industry," the CEO of the EMI Group stated in the

[8] Because of several key commercial successes in the United States in the 2005 fiscal year, Warner Music Group's year-on-year decline in physical sales in the United States was only $13 million. *See* CO Tr. Ex. 21 at 46-47 (Warner Music Group, 2005 Annual Report).

company's 2007 annual report that "[w]e believe that digital sales will continue to grow and we are excited about the possibilities offered by partnerships with new business models." RIAA Tr. Ex. 7 at 9-10 (EMI Group, 2007 Annual Report); Faxon WDT ¶ 35 (CO Tr. Ex. 3) ("Digital music distribution has grown rapidly in recent years and EMI MP expects this growth to continue.").

73. While the digital sector of the recorded music industry holds greater promise for future growth than the physical sector, it is important to recognize that growth in digital sales does not yet come close to offsetting the decline in physical sales. *See, e.g.,* CO Tr. Ex. 29 at CO9008755 (IFPI Recording Industry in Numbers 2007) (noting that U.S. physical sales dropped 15 percent in 2006 and that increases in digital sales have not been sufficient to offset the decline); CO Tr. Ex. 15, attach. 700 at RIAA0018079 (Universal Music Group Presentation, 2006) (worldwide decline in physical sales only partly offset by growth in digital).

74. Legal digital distribution still has not yet achieved what the IFPI calls "Holy Grail" status; it is not yet capable of pulling the recorded music industry out of its current general decline. *See* CO Tr. Ex. 29 at CO9008755 (IFPI Recording Industry in Numbers 2007); *see also* Faxon WDT ¶ 45 (CO Tr. Ex. 3) ("While digital album sales have been increasing (from 4.6 million units in 2004 to 13.6 million units in 2005), they do not come close to replacing . . . lost CD album sales."); RIAA Tr. Ex. 7 at 19, 23 (EMI Group, 2007 Annual Report) (reporting that growth in digital sales has not compensated for the decline in physical sales). Allowing legal digital distribution to reach its fullest potential will require new entrants, additional technological investment and innovation, cost reductions, and incentives for consumers abandon pirate services for music. *See,*

e.g., Cue WDT ¶ 52 (DiMA Tr. Ex. 3); McGlade WDT ¶ 58 (DiMA Tr. Ex. 5); Quirk WDT ¶ 6 (DiMA Tr. Ex. 8).

75. As Roger Faxon testified, there is little value in "making value judgments [about] who is more harmed" by the downturn in the industry. 1/29/08 Tr. 530:14-21 (Faxon). The more important question, he explained, is "who can do more to cure the problem?" *Id.* The answer, as the record demonstrates, is legitimate digital music distributors, but only if the rate set in this proceeding encourages continued growth and technological innovation.

IV. DiMA MEMBERS BRING POWERFUL INNOVATION TO CONSUMERS AND COPYRIGHT OWNERS

76. If allowed to grow unburdened by unreasonably higher costs, legitimate digital distribution can continue to open new avenues for the legitimate sale of creative works and better channels for delivering those creative works to consumers. This, in turn, would expand revenues for all industry participants. As the EMI Group stated in its 2005 Annual Report, a growing digital marketplace would be "beneficial to both [music publishing and recording], fuelling revenue growth and profitability increases." CO Tr. Ex. 45 at RIAA0043152 (EMI Group, 2005 Annual Report). In the words of iTunes' Mr. Cue, digital distribution is "enlarging the overall pie" and "expanding the music marketplace for all industry stakeholders, including copyright holders, and not just cannibalizing sales from physical outlets." Cue WDT ¶ 30 (DiMA Tr. Ex. 3) (emphasis supplied). In other words, digital distribution offers a possible solution to the declining revenue problem that has bedeviled publishers and labels alike.

77. As explained below, legitimate digital music distributors continually invest in technology and features to enhance the consumer experience. The evidence

shows that these efforts have worked. Consumers find legitimate digital music more valuable than physical CDs because of the innovations and features provided by legitimate digital music suppliers. *See, e.g.,* 1/29/08 Tr. 516:2-7 (Faxon) ("There is portability. There is the ability to manage the files, all of those things and others make it a better product, and therefore, a product that is more valuable to consumers."). The innovations and features do more than just please consumers. They also benefit copyright owners because they expose more consumers to more kinds of music and boost overall demand. *See supra* § IV(B), (C). But legitimate digital distributors can perform these vital functions only if they are not saddled with innovation-stifling costs.

A. Legal Digital Distribution Offers Clear Advantages to Consumers

78. Consumers are attracted to legitimate digital distribution services in large part due to their user-friendly technologies and features. *See, e.g.,* 1/30/08 Tr. 854:10-857:11 (Shaw) (confirming that user-friendly conveniences offered by legal digital distributors draw consumers away from pirates). In the short period during which legitimate digital distribution has been a meaningful component of the recorded music industry, DiMA member companies and other legal digital distributors have continuously rolled out service innovations and upgrades that make their services more attractive to consumers. *See, e.g.,* Guerin-Calvert WDT ¶ 54 (DiMA Tr. Ex. 7) (explaining that continued investment by digital music stores is necessary to keep customers coming back after making a purchase).

79. Indeed, marketplace realities require them to do this, since consumers can obtain the same music for free from pirates. Consumers choose the legal option because of the additional features available from legal distributors. *See, e.g.,* Faxon WDT ¶ 48 (CO Tr. Ex. 3) ("Consumers today can purchase music at any time of day, can put music

on their computer, CD, MP3 player and phone and make digital quality copies when this is legally permitted."); 1/30/08 Tr. 851:21-852:3, 854:10-857:11 (Shaw) (confirming that pirate services offer the same music sold by legal distributors, and consumers choose to pay for the legal version because of the distributors' user-friendly conveniences). Mr. Quirk, RealNetworks' Vice President of Music Programming, explained that his company's service must "provide a better experience than peer to peer. We need to make it easier to use, more valuable. We need to do things peer to peer can't in order to convince people that it's worth paying money for music and access to music in this manner." 2/26/08 Tr. 4615:10-17 (Quirk).

80. The benefits of attracting consumers accrue not just to the digital distributors in the form of additional sales, but also to the labels and the copyright owners, who earn no income from consumers who elect to download music from a pirate website instead. *See supra* § III(A)(1).

1. Comprehensive Catalog

81. DiMA members and other legitimate digital distributors provide access to unprecedented music catalogs that are never out of stock. *See, e.g.,* CO Tr. Ex. 45 at RIAA0043152 (EMI Group, 2005 Annual Report) ("Shelf space is unlimited, enabling us to offer the full range of our catalogue including the older hits, specialised genres and music in all languages."); RIAA Tr. Ex. 7 at 18 (EMI Group, 2007 Annual Report) (applauding 24-hour availability, catalog breadth, and unlimited shelf space). Indeed, "a central aspect of consumer demand for digital music is the depth and breadth of catalog, including genres and artists." Guerin-Calvert WDT ¶ 109 (DiMA Tr. Ex. 7).

82. Today, the iTunes Store offers a catalog of 6 million songs, and RealNetworks offers almost 5 million. *See* 2/25/08 Tr. 4236:18-20 (Cue) (stating that the

iTunes Store has "grown the catalog from 200,000 songs when we started to well over 6 million songs today"); 2/26/08 Tr. 4599:18-19 (Quirk) (testifying that Rhapsody is "up to almost 5 million tracks as of this morning"); 2/4/08 Tr. 1333:15-18 (Enders) (confirming that legal digital music distributors strive to provide the widest catalog possible). Likewise, MediaNet – which supports permanent download services and subscription services, *see* McGlade WDT ¶ 5 (DiMA Tr. Ex. 5) – offers over 5 million tracks. *See* 2/25/08 Tr. 4370:10-14 (McGlade). The enormity of these catalogs becomes most apparent when compared with "a typical 'bricks and mortar' music store which may offer 4,500 CD albums and virtually no single tracks for consumers." Guerin-Calvert WDT ¶ 65 (DiMA Tr. Ex. 7); *see also* 2/26/08 Tr. 4611:17-4612:10 (Quirk) (physical retailer may carry at most 5,000 artists while Rhapsody carries 250,000); Sheeran WRT, Ex. B (DiMA Tr. Ex. 11) (the largest Wal-Mart stores carry 4,000 album titles, and the chain may cut that by 20 percent to make room for DVDs and games).

83. As Mr. Quirk explained, although there are associated costs, digital distributors do not have the same type of shelf-space constraints for limited release or out-of-date materials as brick-and-mortar retail establishments:

> It is crucial that our "celestial jukebox" give users access to the largest catalog possible, and that the catalog reflect the incredible diversity of recorded music today. Our catalog includes artists from a wide spectrum of record labels, including a huge collection of independent artists and titles that had fallen out of print. Because our "shelf space" is virtual, we can stock music that is simply not available at physical retail stores such as Wal-Mart or Tower Records.

Quirk WDT ¶ 26 (DiMA Tr. Ex. 8); *but see infra* Section V (costs for digital distribution are high).

84. Witnesses presented by the Copyright Owners acknowledged that these enormous catalogs have "obviously created a [product that is a] lot more attractive . . . to buy." 2/4/08 Tr. 1260:17-1261:1 (Enders); *see also* 1/30/08 Tr. 659:2-9 (Faxon) (recognizing that legal digital services have expanded the music marketplace by making more tracks available than physical retailers); *id.* 669:18-670:6 (Faxon) (recognizing that legal digital services offer music from hundreds of thousands of composers, which is "a great business model"). By offering completely comprehensive catalogs – including specialty genres and older songs unavailable from physical outlets – legal digital services "expand[] consumers' opportunities to buy music." CO Tr. Ex. 45 at RIAA0043152 (EMI Group, 2005 Annual Report). Even EMI Music Publishing's CEO and Chairman testified that digital distributors' ability to give consumers "a broader choice" is a "value-enhancing activity" and "value-added activit[y]." 1/30/08 Tr. 669:18-670:6 (Faxon).

2. Innovative Navigation Technologies for Exploring Music

85. The catalogs offered by legal digital music distributors are so enormous and comprehensive that they would be nearly impossible to navigate if made available in physical form. *See, e.g.,* Quirk WDT ¶ 36 (DiMA Trial Ex. 6) ("No collection of physical music recordings, no matter how large or diverse, can be enjoyed the [same] way . . . . Unless a consumer happens to live near a physical retail store that employs the friendliest and most knowledgeable clerks in the world, he or she will never have access to the kind of recommendations and reviews that Rhapsody provides with the click of a mouse."). DiMA members and other legal digital distributors have turned this physical-world limitation into an online strength, as they have developed powerful searching and linking tools that enable consumers to explore tracks, albums, songwriters, artists, genres, and time periods with ease. *See, e.g.,* Guerin-Calvert WDT ¶ 65 (DiMA Tr. Ex. 7)

("Digital music providers have created, at great expense, websites that enable the music consumer to explore unknown or more obscure musical works across a broad array of different music genres. This ease of use enhances the consumer's ability to think 'outside the box' in consuming new and older music."). Perhaps most importantly, these tools allow for personalized exploration of the catalog based on individual consumers' tastes and interests, and they therefore "encourage[e] users to expand their music consumption, and enhance their purchasing." *Id.*; *see also infra* § IV(B)(1).

86. As Mr. Quirk, RealNetworks' Vice President of Music Programming, explained: "We don't just put music on a virtual shelf. Instead, we give consumers the tools they need in order to find, listen to, evaluate, and collect the music they like." Quirk WDT ¶ 35 (DiMA Tr. Ex. 8). Mr. Quirk noted that his company's service "beat[s] both large retailers and illegal file sharing services for effective discovery of lesser known artists." *Id.* ¶ 27. It does so, he explained, by "provide[ing] intuitive ways to navigate through that wealth of material, and . . . numerous methods to help customers find new music that matters to them." *Id.* ¶ 10. In particular, RealNetworks uses a "style tree" that "classifies all the music in our catalog into over 500 distinct musical genres (Rock/Pop, for instance, has 18 different subgenres, including Metal, which in turn breaks down into a dozen unique subgenres from Black Metal to Speed Metal)." *Id.* ¶ 17.

87. In addition, RealNetworks employs an editorial staff that creates informative features such as artist biographies, album reviews, and "track facts" about individual songs, *id.* ¶ 28, and "assign[s] proprietary 'metadata' to artists, such as styles, similar artists, and key tracks." *Id.* ¶ 29. As Mr. Quirk explained, "[t]his data powers many of our personalization and recommendation features" to guide individual

consumers. *Id.* This level of "personalization . . . make[s] it easy to find music users love and music they don't yet know they love." *Id.* ¶ 21.

88. RealNetworks' comprehensive navigation system also "provide[s] novel ways to identify and organize the artists, albums, and tracks that you like most; paths that lead from the music you like to new music you wouldn't otherwise have discovered; and a community of like-minded music fans with whom you can share your discoveries." *Id.* ¶ 25; *see also id.* ¶ 33 (describing one example of how a customer might discover new music on Rhapsody). Consumer-friendly navigation benefits copyright owners as well "because it makes their music easier for customers to find." *Id.* ¶ 35. This type of exposure to lesser known artists "cannot be matched by a traditional music retailer." *Id.*

89. Mr. Quirk explained that expanding customers' music consumption is essential to RealNetworks. *See* 2/26/08 Tr. 4609:8-14 (Quirk). "[E]xposing [customers] to new music that they wouldn't have known about otherwise" makes Rhapsody more valuable to its customers and draws them to the service, because "all the music we're providing is available completely for free elsewhere on peer-to-peer services." *Id.* 4609:15-4610:3 (Quirk).

90. Mr. Cue testified that the iTunes Store also provides navigation tools that give more consumers more access to more music. In addition to features that allow customers to "search the catalog by artist, by song and even by genre or era," the iTunes Store provides automatic recommendations to customers based on the artists and genres that they have purchased in the past. Cue WDT ¶ 9 (DiMA Tr. Ex. 3). As Mr. Cue explained, the iTunes Store "also provides recommendations for other songs and artists in which a customer might be interested. Each time a customer views a particular album

within [the store, it] gives the customer information about music that other customers interested in the same music also bought" at the store. *Id.* ¶ 17. Moreover, the iTunes Store gives consumers the ability to hear 30-second samples so that they can determine whether they enjoy a particular track or album before deciding whether to buy it. *See id.* ¶¶ 4, 9. These features make shopping on iTunes "a more individualized and rewarding experience than can be found at large physical CD retail outlets, and thereby facilitates repeat visits and additional music purchases." *Id.* ¶ 12. Focusing on the customer experience is important because steady repeat customers represent a disproportionate share of revenues for digital music stores. *See* Guerin Calvert WDT ¶ 54 (DiMA Tr. Ex. 7).

3. Ability to Organize Music Collections

91. Legal digital distribution services have also developed powerful organizational tools that allow their customers to store, catalog, and organize all of the music they own – including music they may have purchased on CD rather than via download. These tools permit customers to "organize their music to fit their personal preferences, such as by genre, artist, date, and so on." Guerin-Calvert WDT ¶ 54 (DiMA Tr. Ex. 7).

92. As Mr. Cue explained, consumers access the iTunes Store through the iTunes Jukebox, a software application that Apple makes available for free download. *See* Cue WDT ¶ 7 (DiMA Tr. Ex. 3). In addition to connecting users to the store, the iTunes Jukebox "acts as a powerful cataloging tool: it allows users to collate and organize their existing personal music collection on their computer." *Id.* ¶ 8. After a customer downloads the jukebox to a computer, it automatically "finds and sorts any digitally encoded music that might be stored on the computer's hard drive and collates it into a

personal library accessible through the iTunes Jukebox interface." *Id.* In addition to locating digital music files already stored on the computer, the iTunes Jukebox "allows users to convert music from their personal CDs into digital files for storage on their computer and import that music into their iTunes Jukebox's so-called 'library' in a choice of different digital formats." *Id.* "Once music has been brought into a user's personal iTunes library, it can either be played back through the computer or be transferred or 'synched' to a portable digital media player so that it can be listened to on the move." *Id.*

4. Appealing and Consumer-Friendly Websites

93. DiMA members and other legal digital distributors also provide user-friendly experiences built around websites that are inviting and easy to use. *See, e.g.,* Quirk WDT ¶ 31 (DiMA Tr. Ex. 8) ("[O]ur software's ease of use is also critical to the appeal of our services."). At the iTunes Store, for example, "[t]he painstakingly designed storefront that greets customers . . . is critical to the success of the store." Cue WDT ¶ 15 (DiMA Tr. Ex. 3). The iTunes Store user interface, Mr. Cue explained, was "designed to provide customers with a reliable and user-friendly retail experience that helps them navigate an enormous music catalog to find and purchase whatever music they are seeking, and increases their exposure to other (in many cases previously unknown) music that they might like – all with a view toward expanding sales and demand." *Id.*

94. In hopes of achieving greater sales and demand, iTunes designed a user interface that makes it "as easy as possible for people to search, browse, sample, and purchase music." *Id.* ¶ 16. To this end, iTunes customers "are greeted with a variety of featured content, lists showing (and links to) featured tracks and songs and albums that are most popular on iTS at the time, and easy links to the many music exploration sections of the store." *Id.*

5. High-Quality Music Reviews and Content Descriptions

95. Beyond providing access to music tracks alone, legal digital distributors also offer consumers immediate, real-time access to reviews and descriptions of music. RealNetworks "invest[s] heavily in this unique editorial content, because we believe it adds significant value to our services in the eyes of consumers." Quirk WDT ¶ 28 (DiMA Tr. Ex. 8) (describing the output of expert editorial staff). At the same time, digital distributors rely on input from their editorial staffs to determine which tracks are likely to appeal to which consumers based on past purchases and samples reviewed. The ability to match song features with particular consumer tastes is critical to legal digital distributors' ability to separate themselves from pirate services. *See, e.g.,* Cue WDT ¶ 22 (DiMA Tr. Ex. 3) ("We pride ourselves on our unfettered editorial discretion, which allows us to focus our features on music we believe customers will enjoy, and allows us to build a relationship of trust and confidence with our customers.").

6. Ability to Share Music and Recommendations with Friends and Others

96. The interactive technologies employed by legal digital distributors have also allowed them to create on-line forums in which like-minded fans can communicate with each other, share ideas and recommendations, and post their own reviews for the use of other listeners. *See, e.g.,* Quirk WDT ¶ 25 (DiMA Tr. Ex. 8) ("[W]e provide . . . a community of like-minded music fans with whom you can share your discoveries."); Cue WDT ¶ 4 (DiMA Tr. Ex. 3) (describing users' ability to post reviews for other consumers).

97. In this regard, iTunes has developed a series of features that empower consumers to share recommendations and actual music with friends: "Customers also

can encourage others to explore music available on iTS through our 'Tell A Friend' email functionality (which allows a customer to send friends an email with a link to a particular album available on iTS), by creating and publishing to iTS, for all customers to see, an iMix collection of tracks selected by the customer (which the customer also can email to friends with a link to iTS), and even by gifting particular tracks or albums to friends via email." Cue WDT ¶ 18 (DiMA Tr. Ex. 3).

7. Instant Availability, 24 Hours Per Day

98. Digital distribution also allows consumers to access and purchase music – and enjoy the features and enhancements described above – at any time of day or night, every day of the year. With regard to his company's services, RealNetworks' Mr. Quirk explained that

> it's available 24 hours a day, 7 days a week, 365 days a year whenever you want to hear music. It doesn't matter if it's after midnight on a Sunday night. Our record store is never closed. Our service is never closed. It's just always there.

2/26/08 Tr. 4600:15-21 (Quirk); *see also* CO Tr. Ex. 45 at RIAA0043152 (EMI Group, 2005 Annual Report) ("Stores are open round the clock and product is never out of stock."). As EMI Music Publishing's Chairman and CEO explained, "[t]here are no store closings," so consumers can access the distributors' offerings at any time. 1/30/08 Tr. 674:18-22 (Faxon); *see also* Faxon WDT ¶ 48 (CO Tr. Ex. 3) ("Consumers today can purchase music at any time of day. . . ."); RIAA Tr. Ex. 7 at 18 (EMI Group, 2007 Annual Report) (applauding 24-hour availability, catalog breadth, and unlimited shelf space); Robinson WDT ¶ 16 (CO Tr. Ex. 8) (lauding "the availability of 24 hour a day access to online music services").

8. Convenient Payment Options

99. In addition to the convenience of remaining open at all times, digital distributors give customers unparalleled payment options, including credit cards, debit cards, the PayPal e-commerce payment system, and prepaid cards affiliated with particular digital distribution services. *See, e.g.,* Cue WDT ¶¶ 4, 10 (DiMA Tr. Ex. 3); McGlade ¶ 13 (DiMA Tr. Ex. 5) (describing MediaNet's role in payment processing for its distributor customers); Quirk ¶ 49(c) (DiMA Tr. Ex. 8) (describing credit card payment processes).

9. Availability of Music in Multiple, Easily Transportable Formats

100. Legal digital distribution services allow consumers to access their music library at home, at work, or anywhere else they may go. *See, e.g.,* Guerin-Calvert WDT ¶¶ 91-92 (DiMA Tr. Ex. 7). As Mr. Quirk testified, digital distribution services like Rhapsody "allow our customers to experience the music they like best at will, whether they are driving their car, walking down the street, relaxing at home, or sitting in front of a computer." Quirk WDT ¶ 9 (DiMA Tr. Ex. 8); *see also* 1/30/08 Tr. 697:19-698:4 (Faxon) (testifying that legal digital distributors enable consumers to purchase music from any location with a computer and an Internet connection). Since legal digital distributors sell music in formats compatible with multiple portable devices, they enable consumers to have thousands of songs and albums at their fingertips at virtually any time. *See, e.g.,* Cue WDT ¶ 8 (DiMA Tr. Ex. 3) ("The iTunes Jukebox is compatible with more than 30 different media players from at least six different manufacturers.").

B. Copyright Owners Benefit from Legal Digital Distribution

101. Taken together, the features described above – all the product of legal digital distributors' technological investment and innovation, *see supra* § IV(A) – attract

consumers by offering them far more than just the songs and albums that they might (or might not) be able to find elsewhere. By attracting more consumers to more music, these features benefit every participant in the recorded music industry. *See, e.g.,* Guerin-Calvert WDT ¶ 12 (DiMA Tr. Ex. 7) ("Growth in the digital pie has substantial spillover benefits for copyright holders, who will gain in the legitimate market sale of their music, and particularly to expand the scale and the scope of offerings relative to traditional CDs."); Cue WDT ¶ 30 (DiMA Tr. Ex. 3).

1. The "Long Tail" Effect: Legal Digital Distributors Produce More Revenue for More Songwriters

102. Because digital distributors give consumers access to unparalleled catalogs of music and a means of navigating through millions of songs, consumers purchase far more than just the "hits" available elsewhere. "All available measures indicate that the [digital distribution] industry in its early stages is substantially expanding the diversity of music offerings and expanding the ease with which diverse and less well known musical works are able to reach consumers." Guerin-Calvert WDT ¶ 11 (DiMA Tr. Ex. 7). And in the end, what concerns songwriters most is not how many songs they write but how many copies of their songs they sell. *See* 1/30/08 Tr. 784:5-19 (Galdston).

103. The EMI Group reported in its 2005 Annual Report that "[d]igital music expands consumers' opportunities to buy music" because it exposes them to "the full range of our catalogue including the older hits, specialised genres and music in all languages." CO Tr. Ex. 45 at RIAA0043152 (EMI Group, 2005 Annual Report). Similarly, Warner Music Group reported in 2005 that "digital distribution will stimulate incremental catalog sales given the ability to offer enhanced presentation and searchability of our catalog." CO Tr. Ex. 21 at 6 (Warner Music Group, 2005 Annual

Report); *see also* 1/30/08 Tr. 694:18-21 (Faxon) (agreeing that legal digital distributors make compositions of relatively unknown artists available in a manner that does not exist in the physical world). This consumption dynamic, often called a "long tail" effect,[9] demonstrates that legal digital distribution has greatly expanded the availability of creative works, as consumers can take full advantage of this unprecedented ability to obtain even obscure recordings.

104. Ralph Peer, Chairman and Chief Executive Officer of Peermusic, Inc., described how "the long tail" offered by digital distribution creates an opportunity for non-hits to reach the paying public. *See* 2/5/08 Tr. 1701:2-9 (Peer); *see also* RIAA Tr. Ex. 9 at CO04032301 (Terra Firma Presentation to Co-Investors, Sept. 2007) (describing value of enabling digital access to the EMI Group's catalog to take advantage of the long tail effect).

105. RealNetworks' Mr. Quirk also described the long tail effect, explaining how royalties accrue to songs ranked far below the top 100 on the charts. This, he noted, demonstrates that "once you make this music available" – including "a lot of this music you couldn't even find in a store" or hear on the radio – people will buy it. 2/26/08 Tr. 4610:18-4611:9 (Quirk). Indeed, Mr. Quirk testified that Rhapsody – which offers permanent downloads and subscription service options, *see* Quirk WDT ¶ 26 (DiMA Tr. Ex. 8) – carries close to 250,000 different artists, and he estimated that "over 90 percent

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[9] The effect is described as a "long tail" because, when presented graphically, the curve representing the sales rankings of songs sold via legal digital distribution stretches far out to the right, like a long tail. *See, e.g.*, 2/26/08 Tr. 4610:9-4611:9 (Quirk); *see also* Quirk WDT at 19, Tables 2 and 3 (DiMA Tr. Ex. 5) (graphically demonstrating the long tail effect).

of that just wouldn't be available in a store and you would never hear it on radio." 2/26/08 Tr. 4612:3-10 (Quirk).

106. The "long tail" also means that songwriters can receive mechanical royalty income for all their works, even relatively obscure songs and recordings. *See, e.g.*, Guerin-Calvert WDT ¶ 66 (DiMA Tr. Ex. 7) ("[D]igital music companies allow users to select from and consume a far wider and deeper catalog of musical works, exposing many more songs to the paying public, and benefiting copyright owners greatly."); *id.* ¶ 69 (Nielsen Soundscan sales data show that "'older' catalog sales account for a larger proportion of total digital albums relative to older catalog sales of physical CDs"); 1/30/08 Tr. 669:1-7 (Faxon) (Wal-Mart and BestBuy have a "limited list of titles" compared to digital distributors). This is a benefit for songwriters. *See, e.g.*, 1/29/08 Tr.246:3-9 (Carnes). Mr. Quirk, himself a songwriter, testified that he has released several records, but "a few of them went out of print physically." 2/26/08 Tr. 4598:21-4599:4 (Quirk). The digital revolution has revived them, however, and made them "accessible to people again." *Id.*; *see also* 4611:10-14 (Quirk). When his songs are purchased, Mr. Quirk earns mechanical royalties that he would not have earned before the advent of legal digital distribution services. *See* 2/26/18 Tr. 4625:18-22 (Quirk) (explaining that he still earns mechanical royalties).

107. Unlike physical retailers, which have space to stock only big sellers, digital retailers make virtually every track available, and the aggregate value of their sales of lesser known works can equal or exceed the value of top sellers. *See* Guerin-Calvert WDT ¶¶ 65, 99 & n.70 (DiMA Tr. Ex. 7). As Mr. Cue explained at trial, "a large retailer isn't going to carry something that is only going to sell 10 or 20 units where we, on the

other hand, will absolutely do that." 2/25/08 Tr. 4251:18-21 (Cue). Mr. Cue further explained that while selling "10 or 20 units may not be a lot," selling 10 or 20 copies of a hundred thousand different tracks generates a significant amount of revenue. 2/25/08 Tr. 4251:22-4252:5 (Cue). Indeed, iTunes learned early on that it "could sell at least one or more of pretty much everything we put into the store," meaning that there is always added value in "expanding the catalog" to make more music available to more consumers. 2/25/08 Tr. 4250:16-20 (Cue); *see also* 2/25/08 Tr. 4252:11-20 (Cue) (over 95 percent of the songs in the iTunes Store catalog have been purchased at least once).

108. This dynamic is particularly important for songwriters and artists whose works are produced by independent labels that "lack the marketing muscle provided by major labels and large retail CD outlets." Cue WDT ¶ 29 (DiMA Tr. Ex. 3); *see also* Guerin-Calvert WDT ¶ 100 (DiMA Tr. Ex. 7). The effort and resources that digital distributors expend have "increased the diversity of musical works available and easily accessible to consumers, which has led to an increase in the relative demand for a wider diversity of musical works." Guerin-Calvert WDT ¶ 77 (DiMA Tr. Ex. 7).

109. Mr. Cue testified in this regard that "iTunes has been called the 'archetypal Long Tail company,' . . . credited with expanding the breadth and diversity of musical works to which consumers are exposed and ultimately purchase – thereby enabling publishers and music companies to 'exploit niche demand more effectively than ever before.'" Cue WDT ¶ 27 (DiMA Tr. Ex. 3). As the International Federation of the Phonographic Industry ("IFPI") reported in its 2007 report on the recorded music industry, "[d]igital distribution and the digitisation of older catalogue are widening the variety or recordings available, resulting in more choice for consumers." CO Tr. Ex. 29

at CO9008758 (IFPI Recording Industry in Numbers 2007). As a result, "[l]ong forgotten recordings can now be offered alongside current titles," which "drives catalogue sales and promotes the so-called long-tail." *Id.*

110. MediaNet's Alan McGlade also commented on the long-tail phenomenon. He explained that his company focuses on "enabling distributors to offer the deepest and broadest possible content catalog around . . . which permits exposure for the most popular songs available on the Internet as well as lesser known, and lesser played, songs." McGlade WDT ¶ 37 (DiMA Tr. Ex. 5).

111. The "long tail" benefits consumers and all industry participants, but the greatest value inures to the songwriters and copyright owners who would otherwise receive nothing (or nearly nothing) for relatively obscure music that legal digital distributors make available to consumers. *See, e.g.,* 2/26/08 Tr. 4598:7-16, 4611:17-4512:10 (Quirk) (describing the substantial benefit to songwriters when "more people listen to more music more often"). As Ms. Guerin-Calvert explained, "[u]sage data show that consumers effectively access the full catalog of music, including older more obscure music, and cumulatively these less frequently accessed tracks account for a substantial portion of downloads and plays." Guerin-Calvert WDT ¶ 12 (DiMA Tr. Ex. 7). "Soundscan estimates that that less than 18% of digital music tracks purchased over the internet are top 200 tracks, while about 82% of digital tracks are part of the long tail phenomena, less frequently purchased tracks that account in sum for a greater proportion of overall sales." *Id.* ¶ 100.

2. Legal Digital Distribution Produces Multiplier Effects by Encouraging Additional Music Consumption

112. In addition to giving consumers access to music that is simply unavailable from most physical retailers, legal digital distributors actually spur greater consumption of music in all formats by increasing the public's exposure to music. By giving consumers "added exposure to new songs and new artists," legal digital distributors "unquestionably ha[ve] a multiplier effect – translating into sales on other occasions and at other outlets." Cue WDT ¶ 20 (DiMA Tr. Ex. 3).

113. "By providing the public with a single source for millions of musical compositions, background information about the songs and the artists, short samples of every song available for purchase, and cross-references to other recordings and artists reflective of a user's interests and tastes," the iTunes Store, for one, "functions not only as a retail outlet for music purchases but also as an informational and promotional vehicle for hundreds of thousands of artists, many of whose works are not readily available at physical retail outlets." *Id.* ¶ 19. This promotional aspect of the iTunes Store and other digital distribution channels "reflect[s] the[ir] core purpose," namely "to increase public exposure to, and purchase of, more music." Cue WDT ¶ 26 (DiMA Tr. Ex. 3); *see also* Kushner WDT at 13 (RIAA Tr. Ex. 62) (iTunes offers "great promotional opportunities" providing "concentrated exposure to people who buy music" that is available "[a]lmost nowhere else").

114. In other words, enabling consumers to explore conveniently a wide range of music online stimulates consumers to purchase more music than they otherwise would, from digital distributors and physical outlets alike. In addition to leading to more sales, legal digital distribution can also lead to the creation of new recordings, thereby

expanding the availability of new music to public. *See, e.g.,* Cue WDT ¶ 21 (DiMA Tr. Ex. 3) ("[A]rtists such as Joshua Radin, Kate Havnevik, and Sandi Thom each obtained recording deals from major labels after their music gained prominent exposure on iTunes. iTunes' 'developing artist program' continues to nurture talented new artists that have yet to gain significant radio or retail store exposure.").

115. Through online exposure via legal digital distributors, individual songs can achieve commercial success unlike anything they could experience from a physical retailer. As Mr. Cue noted, songs featured as an iTunes "song of the week" have gone on to generate extraordinary results on Billboard's charts. *See* Cue WDT ¶ 25 (DiMA Tr. Ex. 3) ("[T]he track 'Bad Day' was the SOTW during the week of August 2, 2005. On October 8, 2005, the track debuted on Billboard's Adult Top 40 chart at #38. By April 8, 2006, the song was #1 on the Adult Top 40 chart and #1 on Hot 100 chart. The track 'Over My Head' was the SOTW during October 11, 2005 and debuted on Billboard's Adult Top 40 on November 19 at #37, peaking on March 25, 2006 at #5 and on the Hot 100 in June at #8."). As Mr. Cue testified, "each song's climb up the charts was directly influenced by its being featured as our [song of the week]." *Id.*

116. Similarly, Mr. Quirk explained that "the availability of an artist's work" on the Rhapsody service generates more sales of that music. Quirk WDT ¶ 42 (DiMA Tr. Ex. 8). When tracks that were once available only for purchase suddenly become available for listening via a subscription service, "download sales . . . dramatically increase" – by a factor of "2X up to 10X." *Id.* For example, when RealNetworks obtained playback rights for Madonna's music, her track sales doubled; when she released a new album, track sales tripled; and when her track sales finally leveled off,

they did so at a sales volume twice as high as when her music was only available for permanent purchase. *See id.* ¶ 42 & Table 4 (illustrating this phenomenon).

117. Roger Faxon agreed that digital services' promotions can boost sales and revenues for particular songs and songwriters:

> When iTunes wants to come to us and it says that they would like to create a promotion around a particular composition, and they ask us to do so without receiving a mechanical royalty with respect to that, if one was implicated, we will certainly do that, if we believe it will increase greater awareness and therefore, the long term value of the copyrights that we are responsible for.

1/29/08 Tr. 404:22-405:8 (Faxon).

118. Mr. Peer likewise testified that being featured as an iTunes artist of the week "can be very important to the commercial success of an artist," in the digital and physical worlds. 2/5/08 Tr. 1701:10-21 (Peer). Mr. Peer noted that Blondfire was featured as an iTunes artist of the week, which led first to Blondfire signing a publishing deal with Peermusic and ultimately to a worldwide record deal with EMI Records. *See, e.g.,* Peer WDT ¶ 32 (CO Tr. Ex. 13); 2/5/08 Tr. 1701:22-1702:7 (Peer).

119. In sum, while legal digital distribution spurs greater consumption of more digital music, it also has valuable spillover effects in the physical world. As Ms. Guerin-Calvert explained, legal digital distribution can "stimulate the demand for . . . physical media sales," and "[t]he majority of fee-based downloaders have purchased an artist's pre-recorded CD after having first paid to download at least one song from the album." Guerin-Calvert WDT ¶ 90 (DiMA Tr. Ex. 7).

3. Legal Digital Distribution Can Boost Demand by Permitting Consumers to Purchase Only the Songs and Albums They Want

120. The consumer-friendly features of legal digital distribution also fuel greater demand for creative works because they facilitate purchase of the songs and

albums consumers want. *See, e.g.,* Enders WDT at 6-7, 61 (CO Tr. Ex. 10) ("In the digital world, consumers have the ability to purchase only the hit song without purchasing the rest of the album."). Notwithstanding the manifest advantages of expanding consumer choice, a parade of publishing executives and their experts lamented the declining fortunes of a product format (*i.e.,* physical CDs) that requires consumers to pay for songs they do not want to buy. *See, e.g.,* Faxon WDT ¶ 49 (CO Tr. Ex. 3); Robinson WDT ¶ 15 (CO Tr. Ex. 8); Israelite WDT ¶ 30 (CO Tr. Ex. 11); Enders WDT at 6-7, 61 (CO Tr. Ex. 10); *see also* 2/4/08 Tr. 1358:11-1359:8 (Enders) (in the digital marketplace, copyright owners are not compensated for tracks consumers do not buy). The Copyright Owners argue that Court should set rates that make up the potential loss of sales of "unwanted 'filler' tracks on CDs." RIAA Tr. Ex. 27 at CO02001073 (Enders Analysis, Recorded Music and Music Publishing, March 2007); *see also* Faxon WDT ¶ 49 (CO Tr. Ex. 3); Robinson WDT ¶ 15 (CO Tr. Ex. 8); Israelite WDT ¶ 30 (CO Tr. Ex. 11).

121. The argument fails for two reasons. First, the ability to purchase single tracks or entire albums based on individual consumption preferences should be recognized for what it is: one more consumer-friendly feature among many technological innovations that, according to industry consensus, has the power to drive growth in digital sales in the years to come. *See, e.g.,* Faxon WDT ¶ 49 (CO Tr. Ex. 3) ("The value of music to the consumer also has increased because consumers have a greater ability now to purchase only the songs they want instead of having to purchase a CD album that may have a few songs they want and other songs in which they are less interested."). There is no precedent for setting rates based on whether consumers are forced to buy

unwanted tracks, and for good reason. The end result would be to discourage product innovation and dampen overall growth of the marketplace.

122. Second, while bemoaning so-called "unbundling," the copyright owners failed to present any actual evidence showing that it has led to lower overall sales or revenue. Indeed, Roger Faxon testified that he has worked extensively on the bundling issue, yet he acknowledged there is no evidence that gross demand for music has gone down due to the availability of unbundled digital singles. *See* 1/30/08 Tr. 716:7-15 (Faxon) (what "actually has happened" in the marketplace "is still an unsettled thing"); *see also* 2/4/08 Tr. 1298:1-20 (Enders) (singles comprised 40 percent of units sold in 1973).

123. Indeed, there is good reason to conclude that the availability of unbundled singles actually boosts demand for music. In the digital world, consumers who enjoy only a few songs on an album can now obtain them without having to pay the full price for the entire album. Consumers unwilling to pay for a full CD, for example, can now pay a fraction of that cost to purchase a few songs. *See, e.g.,* Enders WDT at 19 (CO Tr. Ex. 10) (no evidence that consumers who pay to download a song would have purchased the entire album if single not available). Even if this were to decrease the sales of some albums, it has the power to stimulate demand radically for the individual tracks that consumers actually enjoy. The Copyright Owners conveniently overlook this analysis. *See* 2/4/08 Tr. 1297:4-22 (Enders).

124. This sales dynamic leads to increased efficiencies as well. By enabling consumers to target their purchases on individual tracks, the marketplace generates more complete information about the specific types of music the public demands. Clearer

information about consumer tastes and demand should, all things being equal, lead to the production of songs that better satisfy that demand. As Ms. Guerin-Calvert explained:

> With the advent of an efficient technology for distribution of unbundled musical works, the marketplace is better able to equate price with the value the consumer places on a particular musical work. The ability to unbundle musical works, provides a mechanism by which both individual copyright creators and the owners of aggregated musical works are provided with pricing signals that permit more efficient "production" decisions.

Guerin-Calvert WRT ¶ 19 (DiMA Tr. Ex. 10).

125. Finally, the Copyright Owner witnesses' purported concerns about the demise of album sales in the digital world are overblown. Mr. Cue testified that "over 40% of tracks" sold by the iTunes Store "are sold as part of albums, rather than individually." Cue WDT ¶ 10 (DiMA Tr. Ex. 3). The data provided by the Copyright Owners confirmed this. *See* 2/4/08 Tr. 1355:3-22 (Enders). Indeed, from 2005 to 2006 sales of digital singles sales grew by 59.7 percent while sales of digital albums grew by 103 percent. *See* Enders WDT at 23 (CO Tr. Ex. 10). Regardless of whether album sales overtake singles sales anytime soon, the Copyright Owners' industry statistics refute their general lament that sales of singles are booming while album sales are withering away.

C. Copyright Owners Depend on Technological Investment and Innovation from Legitimate Digital Distributors

126. There is widespread agreement that legal digital distributors offer additional features that make music more attractive to consumers. *See, e.g.,* Peer WDT ¶ 47 (CO Tr. Ex. 13) ("[W]e are greatly excited about the potential for digital music to increase the public's access to our works."); Faxon WDT ¶ 48 (CO Tr. Ex. 3); 1/30/08 Tr. 851:21-852:3, 854:10-857:11 (Shaw). And, likewise, there is widespread agreement that further innovation and investment in technology by legal digital distributors is critical to

the future success of the recorded music industry as a whole. *See, e.g.,* 2/12/08 Tr. 2718:4-15 (Firth) (confirming that technological innovation and the development of new platforms is fundamentally important to the publishing industry, and stating that "music and technological innovation have always been friends to music publishing").

127. Continued investment and innovation are necessary not just for survival but for expansion. Mr. Cue of iTunes has noted that "[t]hese investments are aimed not just at acquiring incremental customers, but at turning those customers into habitual purchasers of music online." Cue WDT ¶ 30 (DiMA Tr. Ex. 3). Dan Sheeran, Senior Vice President of Business Development at RealNetworks, explained the "tremendous amount of work" and investment necessary "to make [Rhapsody] more easily available in the two places that consumers most often enjoy music, which is in their car and in their living room." 5/13/08 Tr. 6158:14-19 (Sheeran).

128. According to songwriters, legal digital distributors' innovations and technological investments have resulted in user-friendly features that attract more consumers. *See, e.g.,* Tr. 1/30/08 852:11-857:11 (Shaw). Indeed, Victoria Shaw, a songwriter who has achieved success in country music, testified before the Senate Judiciary Committee that legal digital distributors "are the services that make the sales we [songwriters] need to survive." DiMA Tr. Ex. 2 at 2 (Victoria Shaw, Testimony Before the Senate Judiciary Committee, April 26, 2006). Ms. Shaw informed the Committee that legal digital distribution is "the bright future of the music industry" because it allows consumers to access music "the way they want, all for prices that are appropriate to consumers and fair to those of us who create it." *Id.* at 1. "This," she told

the Committee, "is why [songwriters] have been so excited by the many new digital services offering our work." *Id.*

129. Music publishers also are enthusiastic about the opportunities that legal digital distribution presents and recognize the importance of promoting further technological investment and innovation. In a June 2006 investment memorandum describing BMG Music Publishing, Citigroup and JP Morgan noted that "Music Publishing has always benefited from technological evolution," and that "[t]oday's proliferation of alternative distribution platforms drives strong demand for content, and particularly music." RIAA Tr. Ex. 51 at CO05006836 (Citigroup and JP Morgan, Investment Memorandum re BMG Music Publishing, June 2006). Indeed, the memorandum states that technological change and advancement form one of the "pillars" on which the music publishing business stands, as they "create[] new revenue sources." *Id.* at CO05006840; *see also id.* at CO05006843.

130. Investment bankers have touted the same potential for revenue growth with respect to another major publisher. A March 2007 Confidential Information Memorandum regarding Famous Music Publishing reported that "Famous is well-positioned to capture digital growth opportunity. Development of new media platforms provide[s] new opportunities to monetize portfolio copyrights." RIAA Tr. Ex. 13 at CO02000848 (UBS Investment Bank, Famous Music Confidential Information Memorandum, March 2007); *see also* 1/31/08 Tr. 1078:4-1079:21 (Robinson) (discussing same).

131. Roger Faxon testified at length about the features that make legal digital distribution "a fabulous model," 1/30/08 Tr. 671:17-672:2 (Faxon), and he urged legal

distributors to continue adding new features that make their services ever more attractive to the public. In response to questions about distributors' technological advances that entice consumers, Mr. Faxon responded: "[M]y answers to all of these questions is keep doing what you're doing, do more of it." *Id.* 672:1-2 (Faxon) (emphasis supplied).

132. Moreover, Mr. Faxon recognized the importance of legal digital distribution in the industry-wide struggle against piracy. In particular, he explained that "the provision of legitimate services in an online environment is an important bulwark against piracy because it offers consumers an alternative," and he noted that the key lies in the "features" that legal digital distributors can develop to make their services more attractive than pirated offerings. 1/30/08 Tr. 657:21-658:4 (Faxon).

133. Among other virtues of legal digital distribution, Mr. Faxon praised the breadth of the services' catalogs, *see id.* 659:10-15 (Faxon), the relative ease of navigating those catalogs, *see id.* 670:12-21 (Faxon), the manner in which they expand consumers' access to music, *see id.* 670:22-671:7 (Faxon), their 24-hour-per-day availability, *see id.* 674:18-2 (Faxon), and the easy portability of digital music. *See id.* 672:20-673:12 (Faxon). As he explained, "all of those things and others make it a better product, and therefore, a product that is more valuable to consumers." 1/29/08 Tr. 516:2-7 (Faxon); *see also* Faxon WDT ¶ 48 (CO Tr. Ex. 3).

134. Similarly, Irwin Robinson – Chairman of NMPA's Board and Chairman and CEO of The Famous Music Publishing Companies – testified that "music in digital form provides additional, unanticipated benefits to consumers not offered by physical copies." Robinson WDT ¶ 16 (CO Tr. Ex. 8); *see also* 1/31/08 Tr. 1039:15-21 (Robinson) ("[Music] is more accessible digitally to the public. They can access music

24 hours a day. They probably have access to more music than they will ever find in a record store. They can put it on portable devices. They can do many more things with it delivered digitally than they could otherwise."); *see id.* 1083:14-1084:10 (Robinson) (listing features). These features, he explained, derive from several unanticipated technological innovations, namely "[t]he rapid emergence and growth of portable music devices, which store more music using less space, the availability of 24 hour a day access to online music services, and numerous other features of digital music distribution." Robinson WDT ¶ 16 (CO Tr. Ex. 8). Mr. Robinson acknowledged that these features – the very characteristics that make legal digital distribution particularly attractive to consumers – are created by DiMA member companies and other legal digital distributors, not by any other industry participant. *See id.* 1/31/08 Tr. 1084:11-1087:9 (Robinson).

135. Dr. Landes voiced strong support for the proposition that ongoing technological investment and innovation attract consumers and, as a result, that they are critical to the future success of the recorded music industry. *See, e.g.,* Landes WDT ¶ 34 (CO Tr. Ex. 22) (technological innovation "will maximize availability of creative works to the public"); *id.* ¶ 37 (innovation in digital distribution will "increase the value of and hence the demand for the underlying musical works, both new and old"). The power of innovation and technological advancement – both recognized by Dr. Landes – have important ramifications for this rate determination. Since, as Dr. Landes testified, technological innovation plays the most important role in the industry's evolution, "the concentration of a given incremental pool of money used to increase distribution technology innovation has the potential to stimulate more output than the same pool of

money dissipated among a large number of copyright owners in the form of royalty compensation." Guerin-Calvert WRT ¶ 31 (DiMA Tr. Ex. 10).

V. COSTS AND RISKS FOR LEGITIMATE DIGITAL DISTRIBUTORS ARE HIGH, AND MANY ARE STRUGGLING TO SURVIVE UNDER CURRENT ECONOMIC CONDITIONS

136. Digital distributors can continue innovating and continue maximizing the availability of creative works to the public only if they can continue to make significant investments in technological advancement by keeping other costs to a minimum. This poses a serious challenge for digital distributors since royalty costs already account for a substantial portion of the revenues that legal digital distributors earn on any sale. *See infra* § V(B)(1).

137. Increasing the mechanical rate and adhering to the penny methodology would jeopardize legal distributors' ability to continue making the technological investments necessary to continue providing the product enhancements that consumers demand. Legal digital distribution shows signs of promise, but disrupting the industry's evolution in this manner will prevent it from realizing its potential to stimulate growth for the music industry as a whole. *See, e.g.,* McGlade WDT ¶ 58 (DiMA Tr. Ex. 5) ("Forcing a legitimate music service to price itself out of the market only results in more piracy activities, which harms both copyright owners and users . . . . A royalty rate that is set too high would be catastrophic to our already vulnerable business model."); Quirk WDT ¶ 6 (DiMA Tr. Ex. 8) ("[I]f excessive costs are imposed on our business, we may be forced to abandon the market to Internet pirates."); Cue WDT ¶ 52 (DiMA Tr. Ex. 3) ("An excessive royalty rate would stifle any effective competition with piracy or the physical retailers, as we would either be forced to raise prices [or] limit further investment in present and future services . . . . The net result would be the same: the

adoption of legal digital music would slow significantly or fall, and this would naturally have ramifications for everyone in the industry, including the artists and composers.").

A. Digital Music Distribution Remains an Evolving Business

138. Notwithstanding Apple's current success with its iTunes Store, legal digital distribution is still a new and evolving business. Indeed, the major record labels only began licensing permanent download sales three years before this ratesetting proceeding commenced. Enders WDT at 7 (CO Tr. Ex. 10). The future prospects of most current and potential digital music distributors are uncertain at best. As Ms. Guerin-Calvert pointed out,

> Even substantial success in this environment by one or a few participants does not provide certainty with regard to customer retention, nor has it resulted in the movement of the industry to a single form of distribution – instead the industry is characterized by increased rather than reduced differentiation.

Guerin-Calvert WRT ¶ 4 (DiMA Tr. Ex. 10). "There is no 'one size fits all' technology that is immediately apparent as the long run technology of choice." Guerin-Calvert WDT ¶ 103 (DiMA Tr. Ex. 7). With technology evolving so quickly, no particular business model is safe. *See* RIAA Tr. Ex. 27 at CO02001086 (Enders Analysis, Recorded Music and Music Publishing, March 2007).

139. In the same annual report in which it praises the potential offered by legal digital distribution, *see* CO Tr. Ex. 21 at 3 (Warner Music Group, 2005 Annual Report) (describing the digital music "renaissance"), the Warner Music Group warns against assuming that legal digital distribution will save the industry. After noting that the period of growth driven by CD sales has ended, the Warner Music Group cautions that "[n]o significant new legitimate audio format has yet emerged to take the place of the CD." *Id.* at 71.

140. The Warner Music Group's mixture of optimism and concern reflects the continually evolving nature of the business. As the EMI Group stated in its 2007 annual report, "[l]egitimate digital product and service offerings are still in the early stages of development." RIAA Tr. Ex. 7 at 28 (EMI Group, 2007 Annual Report).

141. Even witnesses from the music publishing industry have recognized that legal digital distribution business models have been evolving at an extraordinary rate as companies attempt to lure consumers by offering an ever-advancing array of features and services. Mr. Israelite, the President and CEO of NMPA, testified that "the business environment is changing so fast in the digital world," 2/5/08 Tr. 1470:17-19 (Israelite), and Claire Enders, the Copyright Owners' expert on digital music business, noted in her amended report that digital music distribution is "continuing to evolve" as "[o]nline music providers are pursuing a variety of business models." Enders WDT at 18 (CO Tr. Ex. 10). Dr. Landes, the Copyright Owners' lead economic expert, also recognized that digital distribution models – including permanent download models – are new, complex, "vastly more varied" than in the past, and still "rapidly evolving." Landes WDT ¶ 10 (CO Tr. Ex. 22); *see also* 2/11/08 Tr. 2550:2-19, 2551:4-19 (Landes).

142. Ms. Guerin-Calvert explained that "[t]he industry is still in the early stages of development, with competing firms undertaking considerable investments in a variety of technologies and strategies, where market demand and consumer acceptance of technologies and products are still evolving and where piracy is a significant factor." Guerin-Calvert WDT ¶ 6 (DiMA Tr. Ex. 7); *see also id.* ¶ 30 ("The digital industry is at a nascent stage, with competing and differentiated technologies and standards, and with a diverse set of business models for the sale of digital music."); Guerin-Calvert WRT ¶ 8

(DiMA Tr. Ex. 10). Moreover, Ms. Guerin-Calvert noted that the industry continues to evolve in terms of both supply (*i.e.*, distribution methods) and demand (*i.e.*, consumer appetite and acceptance); as a result, "the business models of today may not be the business models that ultimately emerge as the winning solutions to meet consumer demand." Guerin-Calvert WDT ¶ 41 (DiMA Tr. Ex. 7).

143. The pace at which digital distribution models has evolved is particularly noteworthy considering that there were no appreciable sales of digital music until 2004, which was the first year that the industry began tracking and reporting digital sales. *See, e.g., id.* ¶ 32 (analyzing RIAA data, which start tracking digital sales in 2004); 2/6/08 Tr. 1770:4-9 (H. Murphy). Since the digital industry is so new – and since consumer demand for digital services is so far from mature – digital distributors have deployed a "wide range of different business models" and unveiled "new partnerships and technologies," all while contending with "price sensitivity at the consumer level." Guerin-Calvert WDT ¶ 10 (DiMA Tr. Ex. 7).

144. Executives from digital music distribution companies concurred that the industry continues to evolve and require substantial ongoing investment. Mr. Cue of iTunes testified about the significant ongoing investments required to expand the catalog, develop and build new features for the store, and provide new capabilities to consumers. *See, e.g.,* 2/25/08 Tr. 4257:9-4258:16 (Cue). Likewise, MediaNet's Mr. McGlade testified that there are "many creative approaches . . . that have not been explored yet." 2/25/08 Tr. 4380:14-17 (McGlade); *see also* 5/13/08 Tr. 6156:2-15 (Sheeran) (describing planned investments to improve offerings, platforms, and marketing over the next five years); *id.* 6158:1-4 (Sheeran) (testifying that investments cannot be postponed).

145. Taken together, the testimony presented at trial undercuts the notion that legal digital distribution – even for permanent downloads – is a well-established or stable industry. To the contrary, the record demonstrates that legal digital distributors continue to invest in technological enhancements and innovations in an effort to attract sufficient numbers of consumers to allow their businesses to succeed.

146. This is directly relevant to the Court's task. To achieve the objectives set forth in the statute, the Court's rate determination "must be sufficiently flexible to account for a variety of business models, uncertainties and financial risks associated with the ongoing evolution and development of the industry." Guerin-Calvert WDT ¶ 15 (DiMA Tr. Ex. 7); *see also id.* ¶¶ 21, 64.

B. Legal Digital Distributors Bear Substantial Costs and Make Substantial Investments in Technology to Provide Consumers with Innovative Services and Features

147. Providing enticing user-friendly digital services, and continually upgrading them with innovative technological contributions, imposes a substantial and unavoidable cost on legal digital distributors. *See, e.g.,* Quirk WDT ¶ 48 (DiMA Tr. Ex. 8) (describing the "multi-million dollar investments" required to "provide a compelling digital music service"); Guerin-Calvert WDT ¶ 72 (DiMA Tr. Ex. 7) ("Digital music service providers must expend considerable capital for startup to launch a digital music service, and once established, additional capital is continually invested to enhance and update these services."); McGlade WDT ¶ 7 (DiMA Tr. Ex. 5) (explaining that "MusicNet has invested nearly seventy million dollars in technology infrastructure"); 2/5/08 Tr. 1705:10-13 (Peer) (acknowledging the substantial costs related to digital music distribution).

148. While legal digital distributors do not "face the same type of manufacturing and distribution costs that the physical retail model faces in manufacturing and physically distributing a CD," they are subject to "a whole host of other very significant costs that do not have any counterpart in the offline world." Cue WDT ¶ 42 (DiMA Tr. Ex. 3). "[P]roviding that large a catalog of music to a mass audience and . . . having it available 24 hours a day, 7 days a week, 365 days a year, when potentially, millions of people are accessing the system at the same time and playing songs and downloading songs, [and] building the technological infrastructure to allow that is an incredibly expensive undertaking." 2/26/08 Tr. 4612:21-4613:8 (Quirk). Moreover, it is not a one-time cost, but "something you constantly have to maintain and keep going." *Id.* 4613:9-11 (Quirk). For example, RealNetworks' technological development team spent six to eight weeks doing little other than preparing for Christmas Day in 2007 to make sure the system would not fall over with the vast number of people who would access it that day. *See id.* 4613:12-4614:3 (Quirk).

149. The new digital marketplace leaves distributors with no choice but to accept these costs. Not only must they bear the daily expenses of operating their businesses, but they must also "constantly replenish [their] investments in transmission technology, security measures, online site design and capabilities, and customer service simply to compete with well-established brick-and-mortar retail music outlets and to stay ahead of unlawful competition from pirate services that facilitate the unauthorized distribution of music for free." Cue WDT ¶ 5 (DiMA Tr. Ex. 3); *see also* McGlade WDT ¶ 12 (DiMA Tr. Ex. 5) (explaining many potential new entrants contemplating the digital music business are reluctant to "deal with the complexity of developing a technology

infrastructure and delivery system because they require a constant upgrade with new features and functionalities . . . [or with] securing rights from content owners and reporting and paying such parties"). While the burden falls on legal digital distributors, "[c]opyright owners benefit significantly from all these investments." Guerin-Calvert WDT ¶ 104 (DiMA Tr. Ex. 7).

150. The costs and investments that legal digital distributors must incur – and the attendant risk they bear – have direct relevance to this proceeding. "[T]he more costly it is to make music available and sold legally, the greater the proportion of risk borne by the investor (digital music provider) and therefore, the greater the proportion of returns that should be accrued to the digital music provider to entice these investments." Guerin-Calvert WRT ¶ 7 (DiMA Tr. Ex. 10).

151. Several of the principle costs of operating a legal digital distribution enterprise are described below.

1. Licensing and Content Acquisition Costs

152. Unlike digital pirates, legal digital distributors obtain the requisite licenses from copyright owners before selling music to customers. Content costs are high (and content license structures are onerous) principally because having the largest possible catalog of songs is a non-negotiable requirement for any digital service intending to stay in business. *See, e.g.,* 2/25/08 Tr. 4247:6-4248:6 (Cue) (iTunes seeks the largest catalog for competitive reasons, so as not to lose any potential customer); 2/25/08 Tr. 4236:11-4237:6 (Cue) (one of the "mainstays of building the store" was to try to have "every song available in the world for purchase."); 2/26/08 Tr. 4609:5-4610:3 (Quirk) ("it's the mandate for my team" to have the deepest catalog possible); 2/26/08 Tr. 4614:11-14 (Quirk) (service is only valuable to consumers "to the extent [we] have exactly what

[they're] looking for exactly when [they're] looking for it."); 5/13/08 Tr. 6169:22-6170:2 (Sheeran) ("Our service is completely uncompetitive in the market if it doesn't have a broad range of content."); *see also* Enders WDT at 11 (CO Tr. Ex. 10) (noting that early digital music services were unattractive to consumers, and therefore unsuccessful, because they did not offer music from all of the major record companies); 2/4/08 Tr. 1260:22-1261:1 (Enders) (larger iTunes catalog "create[s] a lot more attractive product"); 2/4/08 Tr. 1333:10-18 (Enders) (digital services seek the broadest possible catalog); 2/11/08 Tr. 2525:17-2526:3 (Landes) (same); 2/5/08 Tr. 1703:16-21 (Peer) (same). As a result, sound recording rights holders have substantial power over price and can extract unreasonable payment terms from digital music distributors. *See* 5/13/08 Tr. 6170:2-6 (Sheeran) (without any major content catalog, the service is at a competitive disadvantage); *cf.* 2/20/08 Tr. 3962:1-7 (Wilcox) (dual disk failed because not every song was available in that format).

153. In addition, the process for obtaining content and ensuring that it is properly licensed is "[a]mazingly complex and administratively cumbersome." Quirk WDT ¶ 51 (DiMA Tr. Ex. 8). It is also very expensive, as royalty costs "represent a very substantial percentage of revenues" for digital music stores. Guerin-Calvert WDT ¶ 83 (DiMA Tr. Ex. 7). RealNetworks spends approximately $40 million per year on content acquisition and licensing. *See* Quirk WDT ¶ 49(a) (DiMA Tr. Ex. 8); *see also id.* ¶ 58 ("Royalty payments take up the bulk of our product margins."). Likewise, Mr. Cue testified that licensing the music that populates the iTunes Store's vast catalog is "[t]he most significant cost that iTS has to meet." Cue WDT ¶ 44 (DiMA Tr. Ex. 3). In fact,

the iTunes Store's royalty payments "amount to approximately seventy percent of . . . gross revenue." *Id.* [10]

2. Catalog Maintenance and Ingestion Cost

154. In addition to the cost of licensing content, legal digital distributors must bear the substantial cost of maintaining millions of individual tracks and albums in formats that allow for seamless access by consumers, as well as the cost of continuously "ingesting" new music to keep their catalogs comprehensive and up to date. *See, e.g.,* Quirk WDT ¶ 51 (DiMA Tr. Ex. 8) (describing the cost and complexity of maintaining RealNetworks' catalog and ingesting new tracks); Cue WDT ¶ 43 (DiMA Tr. Ex. 3) (describing cost of maintaining a catalog containing millions of songs); Guerin-Calvert WDT ¶ 84 (DiMA Tr. Ex. 7) (describing ingestion cost).

155. Mr. McGlade described the extensive process that MediaNet must undertake to ingest the works it receives from the record labels, which can arrive in many different raw forms including CDs, hard drives, and electronic files. First, MediaNet must convert the raw audio content and metadata it receives from record labels into copyright-protected reproductions, and it must "perform[] significant quality control procedures" to ensure the quality of the resulting file. McGlade WDT ¶ 42 (DiMA Tr. Ex. 5). MediaNet must also adjust a variety of settings pertaining to each individual song

[10] Completely inverting the third statutory objective – which in part requires a rate calculated to reflect relative costs, *see* 17 U.S.C. § 801(b)(1)(C) – the Copyright Owners suggest that digital distributors' enormous expenses for royalties in general somehow justify higher payments for mechanical royalties in particular. *See, e.g.,* 5/20/08 Tr. 7263:1-8, 7272:8-12, 7273:5-13 (Landes) (explaining that he assessed the Copyright Owners' rate proposal by assessing relative payments for mechanical royalties with payments for other royalties, and comparing the resulting ratio to other royalty regimes); 2/11/08 Tr. 2374:3-4 (Landes) ("[I]t's the relative value that's the key . . . not the absolute value."); *see also infra* ¶ 286.

"to manage the usage and availability rules established by the content owners," and it sets the pricing applicable to each individual track. *Id.* Finally, the company places the audio files and associated metadata on its output servers "so that they can be made available to consumers though our various distribution partners." *Id.* Mr. McGlade explained this process was crucial to delivering CD-quality reproductions to consumers and "ensur[ing] that each original work is compatible with the online hardware and software structure of each of its distributors." *Id.* ¶ 43. Between 2003 and 2006, MediaNet spent approximately $3.4 million dollars on this process. *See id.*

156. Mr. Quirk explained the complexity and high cost of ingesting works into Rhapsody's extensive catalog. He testified that, to manage the various rights associated with the catalog, RealNetworks must keep track of "five label rights per track, five publisher rights per track, five media formats per track, and up to two-hundred label data points per track." Quirk WDT ¶ 50 (DiMA Tr. Ex. 8). Managing this information – composed of more than one billion data points – requires a staff of twelve and costs RealNetworks more than $1 million per year. *Id*

3. Hosting and Server Costs

157. Legitimate digital distributors also incur significant costs to provide the hosting services – and associated server capacity – necessary to make millions of high-quality tracks available simultaneously and seamlessly to millions of consumers. *See, e.g.,* McGlade WDT ¶¶ 44, 47 (DiMA Tr. Ex. 5); Quirk WDT ¶ 49 (DiMA Tr. Ex. 8) ("We incur substantial ongoing maintenance and operating costs in hosting and delivering our services."); Guerin-Calvert WDT ¶ 83 (DiMA Tr. Ex. 7) (recognizing hosting costs).

4. Cost of Developing, Maintaining, and Upgrading Powerful Yet Pleasing Web Interfaces

158. To stay one step ahead of competing pirate services, legal digital distributors also bear substantial start-up costs to develop user-friendly Internet websites, and they must then invest continuously to improve online site designs to ensure that the consumer experience remains "fast, clean, intuitive, and easy for even beginners." Cue WDT ¶ 43 (DiMA Tr. Ex. 3); *see also id.* ¶ 41 ("To continually attract repeat buyers and increase the frequency of other buyers, we are constantly investing in making the store easier to use and more appealing to consumers."); Quirk WDT ¶ 31 (DiMA Tr. Ex. 8) ("[O]ur software's ease of use is also critical to the appeal of our services. The more intuitively our services work, the more likely users are to explore the catalog and get hooked."); Guerin-Calvert WDT ¶ 61 (DiMA Tr. Ex. 7).

159. While user friendly, the online interfaces must also be powerful as they must give consumers the capability to "navigate an enormous music catalog to find and purchase whatever music they are seeking." Cue WDT ¶ 15 (DiMA Tr. Ex. 3). In the case of the iTunes Store, this "extremely costly" development process has resulted in a "sophisticated yet user friendly software application" that "provide[s] an attractive and competitive alternative to piracy." *Id.* ¶ 43. As Mr. Cue explained, "[t]he painstakingly designed storefront that greets customers who visit the iTS is critical to the success of the store." *Id.* ¶ 15.

5. Cost of Transmission and Transmission Technology

160. As in most businesses, delivering an appealing and convenient final product to consumers is critical to retaining existing customers and attracting new ones. As a result, legal digital distributors incur substantial costs to refine and streamline their

content delivery processes. *See, e.g.,* Quirk WDT ¶ 49 (DiMA Tr. Ex. 8). This entails substantial expenses for the bandwidth necessary to carry the enormous volumes of data they transmit to their customers, *see, e.g., id.* ¶ 49(d) (detailing bandwidth costs); Cue WDT ¶¶ 43, 45 (DiMA Tr. Ex. 3) (same), as well as ongoing investment in upgrading the data transmission and compression technologies that they employ to make the process more efficient. *See, e.g.,* Cue WDT ¶ 5 (DiMA Tr. Ex. 3) ("iTS must constantly replenish its investments in transmission technology . . . to compete with well-established brick-and-mortar retail music outlets and to stay ahead of unlawful competition from pirate services."); Quirk WDT ¶ 49(d) (DiMA Tr. Ex. 8) ("The amount of technology and infrastructure needed to provide a fast, secure, and reliable music service is staggering. . . . [W]e are always spending resources to stay ahead of the technology curve and prepare to react competitively to industry trends.").

161. In this regard, Mr. Cue informed the Court that his company "chose the AAC codec to encode our music as it provides near CD quality sound at higher compression rates than the MP3 files more commonly favored by illegal file sharers." Cue WDT ¶ 37 (DiMA Tr. Ex. 3). As a result, "the files purchased from iTS are smaller than those being distributed via peer-to-peer networks, which results in quicker download times, greater ease, and better quality music in a product that also takes up less space on an individual's computer hard drive, portable player, or mobile phone." *Id.*

6. Marketing Costs

162. Because purchasing music online is a relatively new concept for most consumers, and because many consumers are accustomed to acquiring digital music for free, *see, e.g.,* Guerin-Calvert WDT ¶ 40 (DiMA Tr. Ex. 7), comprehensive marketing efforts and consumer education programs are critical to the success of legal digital

distribution companies. *See, e.g.,* Quirk WDT ¶ 49(b) (DiMA Tr. Ex. 8); 2/26/08 Tr. 4615:18-4616:9 (Quirk) ("marketing . . . is a huge expense" because it aims to change consumer perceptions and behavior). Investments in marketing and promotion are "one of the most significant operating costs incurred by [digital music distributors] and one that is critical to sustaining and growing the business." Guerin-Calvert WDT ¶ 80 (DiMA Tr. Ex. 7); *see also* 2/4/08 Tr. 1244:1 (Enders) (noting how digital distribution is "very marketing-intensive"). The Copyright Owners themselves do not dispute the importance of these marketing expenditures. *See, e.g.,* 2/5/08 Tr. 1704:9-11 (Peer).

163. Executives from digital distribution enterprises have identified marketing as a "critical investment needed to stimulate the necessary usage required to grow the business and hence, achieve critical levels of revenue to be sustainable in the long run." Guerin-Calvert WDT ¶ 84 (DiMA Tr. Ex. 7); *see also id.* ¶ 89. Accordingly, these executives predict that their marketing costs will "increase substantially over the coming years," *id.*, because they require "constant reinforcement." 2/26/08 Tr. 4616:8-9 (Quirk). As Mr. Cue explained, "[t]here is a real need to educate the public on the benefits of purchasing legal online music particularly given the incumbency of the physical retail market (and the familiarity of the music buying public with CDs), the infancy of the legal online music market, and the fairly established nature of illegal downloads." Cue WDT ¶ 47 (DiMA Tr. Ex. 3).

164. Ms. Guerin-Calvert's analysis of the industry recognized the "major marketing challenges" related to "educat[ing] consumers about the use of new technologies and methods." Guerin-Calvert WDT ¶ 11 (DiMA Tr. Ex. 7). As she explained, the marketing challenge of convincing consumers to pay for music through

legitimate providers is particularly pressing with respect to "those in the high school and college age demographic group used to consuming music for free or from illegal file-sharing." *Id.* ¶ 40. As a result, "[c]ontinuing investment in marketing and promotion are imperative for these companies to create demand for their services and convince on-line consumers that these services provide value-added worth paying for." *Id.* ¶ 50.

165. The marketing budgets of individual digital distributors demonstrate just how substantial the costs are. The costs for Napster – which offers permanent downloads and subscription services, *see* Enders WDT at 27, Table 6 (CO Tr. Ex. 10) – are illustrative. Its marketing costs rose from just under $14.5 million in 2004 (a figure that exceeded the company's total revenues for that year) to more than $39.5 million in 2006 (which amounts to nearly 50 percent of the year's total revenues). *See id.* at 55, Table 10-H.

166. These marketing expenses have a direct impact on the availability of works to consumers, on the relative contributions of the industry participants, and on the ability of digital music distributors to earn a fair income. Only the copyright users bear these costs, but they result in sales that benefit copyright owners and copyright users alike. Guerin-Calvert WDT ¶ 50 (DiMA Tr. Ex. 7); *see also supra* § IV(B)(1), (2). For these reasons, as Ms. Guerin-Calvert explained, "the rate structure and level set in this proceeding need to take into account ongoing substantial investments in marketing and research, as well as uncertainty associated with consumer acceptance and choice." Guerin-Calvert WDT ¶ 14 (DiMA Tr. Ex. 7).

7. Cost of Producing and Updating Editorial Content

167. As explained above, legal digital music distributors separate themselves from competing pirate services in part by offering consumers detailed music reviews,

recommendations for music that matches a consumer's tastes, and a system that rates and categorizes music to help consumers navigate swiftly through millions of available songs. *See supra* § IV(A)(5). Maintaining this level of editorial content requires legal digital distributors to employ staffs of editors who have deep familiarity with an enormous range of music. Despite the large costs, legal digital music distribution companies "invest heavily in this unique editorial content, because we believe it adds significant value to our services in the eyes of consumers." Quirk WDT ¶ 28 (DiMA Tr. Ex. 8); *see also* Cue WDT ¶ 22 (DiMA Tr. Ex. 3) ("We pride ourselves on our unfettered editorial discretion, which allows us to focus our features on music we believe customers will enjoy, and allows us to build a relationship of trust and confidence with our customers."); Guerin-Calvert WDT ¶ 61 (DiMA Tr. Ex. 7).

8. Cost of Security Features

168. Legal digital music distributors also devote substantial resources to ensuring that the services they offer are secure, both with respect to the music they transmit to customers and personal and payment data that customers transmit to the providers. *See, e.g.,* Cue WDT ¶ 5 (DiMA Tr. Ex. 3) (noting that the iTunes Store invests continuously to ensure that its digital distribution channel is secure). Providing robust security protections for digital rights and for customers' data is "necessary to provide a compelling digital music service." Quirk WDT ¶ 48 (DiMA Tr. Ex. 8).

169. Apple has developed proprietary digital rights management ("DRM") software that "allows iTunes to enforce the content usage rules agreed with the content providers, and to set the parameters within which the songs can be used." Cue WDT ¶ 11 (DiMA Tr. Ex. 3); *see also id.* ¶ 37 ("[W]e developed and employed our own proprietary DRM, Fairplay, in conjunction with the AAC file format, in order to ensure that there

was a fair balance between the ability of the user to enjoy the music and proper protection of the rights of the copyright holders."). As Mr. Cue stated in his written testimony, "[t]he sophisticated yet user friendly software application, together with the encoding and digital rights management techniques that form an integral part of our strategy to provide an attractive and competitive alternative to piracy, have been extremely costly to develop and to maintain." *Id.* ¶ 43.

170. Likewise, Mr. Quirk explained that RealNetworks incurs "substantial expenses for the creation and implementation of a comprehensive digital rights management solution that will work on as many different platforms and devices as possible." Quirk WDT ¶ 49(e) (DiMA Tr. Ex. 8). RealNetworks has undertaken the expense of developing this DRM "solution" in order to meet content owners' portability demands while providing maximum availability of music to consumers. *See id.*

9. Payment Processing Costs

171. Digital distributors also face rapidly growing credit card processing fees and costs associated with credit card security and fraud prevention. *See, e.g.,* Guerin-Calvert WDT ¶ 83 (recognizing credit card processing costs). Mr. Cue noted, for instance, that "the sale of single downloads generates proportionally far higher credit card transaction costs" resulting in a situation where "margins on small purchases typically are either non-existent or negative." Cue WDT ¶ 49 (DiMA Tr. Ex. 3). Likewise, explained Mr. Cue, "because the vast majority of customer transactions are consummated with credit cards, we face a significant amount of credit card fraud risk," in part because "copyright owners demand payment for downloads even if we do not get paid due to fraud." Cue WDT ¶ 49 (DiMA Tr. Ex. 3).

C. Legal Digital Distributors Must Continue To Invest Despite Significant Marketplace Risks

172. While consumer demand and competitive pressure from free pirate services require legal digital music distributors to invest heavily in technology upgrades and enhancements, they must make these sizeable capital commitments in an evolving, high-risk marketplace. In large part, the risk of marketplace failure arises directly from the intense competitive threat posed by illegal downloading, which gives consumers unlimited and free access to the same music that legal distributors sell for a fee. *See, e.g.,* Guerin-Calvert WDT ¶ 10 (DiMA Tr. Ex. 7) ("[P]rofitability is still volatile and uncertain given consumer choices and the need to adapt to a variety of industry pressures, including the availability of free music from pirate sites.").

173. Notwithstanding the risks, legal digital distributors must continue to invest heavily in technological enhancements to provide consumer-friendly features to lure customers away from the illegal alternative. *See supra* § III(B). The prospect of a high mechanical rate compounds this risk, as it would directly affect the ability of legal distributors to price products aggressively enough to attract consumers to the legitimate product. *See, e.g.,* Cue WDT ¶ 52 (DiMA Tr. Ex. 3); McGlade WDT ¶ 58 (DiMA Tr. Ex. 5); Quirk WDT ¶ 6 (DiMA Tr. Ex. 8).

174. For many digital distributors, this marketplace dynamic leaves them teetering on the edge of unprofitability. "With non-royalty bearing music available through illegal file-sharing, consumers must determine that there is value in paying to consume music through legitimate providers." Guerin-Calvert WDT ¶ 89 (DiMA Tr. Ex. 7); *see also id.* ¶ 102; Guerin-Calvert WRT ¶ 7 (DiMA Tr. Ex. 10) ("Digital distributors

must invest in innovative products to the user that distinguish their products from the musical works available from non-legitimate sources.").

175. Ms. Guerin-Calvert testified about the "large number of failed and merged entities" that have attempted to achieve positive margins in the digital distribution industry, *see* Guerin-Calvert WDT ¶ 48 (DiMA Tr. Ex. 7), and she explained that the industry's volatility – and particularly the trend of marketplace exits – has relevance to this proceeding. *See id.* ¶ 49. In this regard, she noted that AOL – a "large, multimedia, internet savvy firm with strong marketing, promotion, and investment resources" – was never able to bring MusicNow to profitability after acquiring it in 2005. *Id.* The number of digital music distributors that have exited the marketplace is so large, Ms. Enders testified, that she "cannot provide . . . a complete list" of them. 2/4/08 Tr. 1198:11-17 (Enders).

176. Likewise, Mr. McGlade informed the Court that MediaNet has still not turned a profit, *see* McGlade WDT ¶ 38 (DiMA Tr. Ex. 5), or met investors' expectations. *Id.* ¶¶ 49, 50; *see also* CO Tr. Ex. 104 (MusicNet, Inc. Consolidated Financial Statements, December 31, 2005) (setting forth MusicNet's net loss of $20,948,208, operating loss of $21,235,544, and stockholders' total deficit of $23,493,548). From 2002 through 2006, on an annualized basis, MediaNet's operating costs exceeded gross profits by $14 million. *See* McGlade WDT ¶ 38 (DiMA Tr. Ex. 5). In 2002, the company had net losses of nearly $20 million; in 2003, its net losses were nearly $15 million; and in 2004 its net losses were $12 million. *See id.* ¶ 46; *see also id.* ¶ 48 (further discussing how the high costs of content and technological investment

requirements have resulted in substantial losses in the years 2003-2005); CO Tr. Ex. 104 (MusicNet Consolidated Financial Statements, December 31, 2005).

177. Mr. McGlade explained, using 2004 as an example, how MediaNet's costs for obtaining, ingesting, storing, and rolling-out songs to its distributor customers totaled $15,934,000. *See* McGlade WDT ¶¶ 47 (DiMA Tr. Ex. 5). He testified that the company's losses have largely stemmed from these types of costs – which are geared toward enhancing the consumer experience. *See id.* ¶ 46; *see also id.* Ex. D (MusicNet Statement of Operations – 2002 to 2004), Ex. E (MusicNet Statement of Operations – 2001), Ex. H (Annual Operating Loss for MusicNet, Inc., 2001-2005 Chart). He explained as well, however, that MediaNet spent an additional $15,494,000 in 2004 on the variable costs of selling music, such as content acquisition costs, bandwidth, server hosting and other storage systems. *See id.* ¶ 47. In aggregate, these costs dwarfed the company's 2004 revenues of $19,456,000. *See id.*

178. The tremendous financial difficulties faced by digital music distributors do not mean that these businesses are inefficient or doomed to fail. Mr. McGlade testified that MediaNet could succeed, but that success is unlikely if his business model is locked into its current form, *see, e.g.,* 2/25/08 Tr. 4378:2-20 (McGlade), or unable to craft service offerings and pricing plans flexibly. *See id.* 4380:8-4381:15 (McGlade); *id.* Tr. 4376:6-4377:2 (McGlade) (pointing to delayed projection for MediaNet's break-even date).

179. Other digital distributors face comparable financial hardships. RealNetworks, for instance, "achieved $149 million in revenue [in 2007] but had an operating loss of $60 million." Sheeran WRT ¶ 7 (DiMA Tr. Ex. 11). Noting that other

companies have experienced similar losses – collectively totaling "hundreds of millions of dollars" – RealNetworks' Mr. Sheeran expressed no surprise that many companies "have had to sell or shut down these services in recent years." *Id.* ("A partial list of such companies includes Yahoo, AOL, MTV Networks, MusicNow, Virgin Media, MusicMatch, and Listen.com."); *see also id.* ("Increasing our costs will not only make these existing economics even more difficult, it also will make it harder for those of us who remain to continue to invest in innovations like new portable devices, new distribution channels, or creative marketing.").

180. Of course, marketplace risk has not driven out every legal digital distributor. The iTunes Store has established a highly successful presence in the online music distribution industry. *See supra* § III(B)(2); *infra* § VIII(A)(4). The company's path to success provides an important example of the type of contributions required to grow the digital music marketplace. *See, e.g.,* 2/25/08 Tr. 4239:16-4240:4 (Cue) (describing the iTunes Store's strategy for competing against pirates).

181. For the iTunes Store and others, however, the mechanical rate has a direct impact on their returns, and an unduly high rate will thus reduce the capital these enterprises can devote to innovating further and expanding the availability of music to the public. *See, e.g.,* Cue WDT ¶ 52 (DiMA Tr. Ex. 3); McGlade WDT ¶ 58 (DiMA Tr. Ex. 5); Quirk WDT ¶ 6 (DiMA Tr. Ex. 8). For some potential new entrants, higher costs may deter entry altogether. *See, e.g.,* Guerin-Calvert WRT ¶ 8 (DiMA Tr. Ex. 10). Success is unlikely if digital distribution is locked into its current form, *see, e.g.,* 2/25/08 Tr. 4378:2-20 (McGlade), or if distributors are unable to price flexibly and respond to market demand for innovation. *See id.* 4380:8-4381:15 (McGlade).

D. While Their Costs and Risks Are High, Legal Digital Distributors Face Unyielding Pressure to Keep Prices Low

182. Existing marketplace conditions strain legal digital music distributors' ability to earn a fair income reflecting the contributions they make, the costs they bear, and the risks they endure. *See, e.g.,* McGlade WDT ¶ 54 (DiMA Tr. Ex. 5) ("[W]e will continue to compete against free music in an environment where broadband access and technology make it easier and easier for consumers to bypass the market and find what they want to play and share with each other without paying for it. This is a developing market. Until the business is proven, costs need to be kept down."). As Ms. Guerin-Calvert testified, "the cost structures underlying these business models are highly vulnerable to additional costs." Guerin-Calvert WDT ¶ 49 (DiMA Tr. Ex. 7).

183. This is particularly true because legal distributors face downward price pressure. As Claire Enders explained, all digital distributors – "including Amazon and iTunes" – must "price aggressively to gain a foothold." RIAA Tr. Ex. 27 at CO02001076 (Enders Analysis, Recorded Music and Music Publishing, March 2007). Indeed, the iTunes Store "attempted to offer a higher price for DRM-free single downloads, but it was unable to make that higher price point stick." Guerin-Calvert WRT ¶ 14 (DiMA Tr. Ex. 10). Moreover, recent entrants have adopted prices – like Amazon.com's 89 cents per song – that "indicate[] that pricing pressure remains strong and that prices will likely decline or remain stable rather than increase." Guerin-Calvert WRT ¶ 14 (DiMA Tr. Ex. 10) (emphasis supplied). As this testimony makes clear, the existing penny rate places legitimate digital music distributors in a tightening vice. While it has not prevented all price reductions to date, it without question exacerbates the challenge created by intense downward pricing pressure because it remains a inflexible cost component that bears no

relationship to actual conditions facing the industry. *See, e.g.,* Guerin-Calvert WDT ¶ 10 (DiMA Tr. Ex. 7) ("The industry continues to evolve . . . with price sensitivity at the consumer level."); *id.* ¶ 30 ("The widespread availability of [pirated] downloads . . . means that digital media companies need to keep prices at very attractive levels.").

184. While the Copyright Owners suggested that legal distributors would pass at least some of the cost of a rate increase on to consumers, *see, e.g.,* 5/19/08 Tr. 6992:21-6993:10 (K. Murphy), higher retail prices would push increasing numbers of consumers to abandon legitimate services and turn to illegal pirates instead. *See, e.g.,* Quirk WDT ¶¶ 45-46 (DiMA Tr. Ex. 5) (explaining that customers will reject retail prices that are too high and "decide to obtain their music from illegal sites that don't pay royalties to anyone."). As a result, legal digital distribution services have to price aggressively and cut their margins to the bone. In fact, many legal distribution companies operate with negative margins, hoping that they can secure enough customers to become profitable before their resources run dry. *See, e.g.,* McGlade WDT ¶ 54 (DiMA Tr. Ex. 5) ("Fundamentally, our hurdle in the near term is to reach sufficient scale so as to become profitable in a very difficult competitive environment.").

185. Subjecting legal digital distributors to an unduly high mechanical rate would exacerbate the financial vice-grip in which many of them operate. MediaNet's Mr. McGlade explained that the "statutory mechanical rate will have a significant impact on our business because, even if we are able to attain profitability, our margins will remain slim. . . . A royalty rate that interferes with our ability to acquire new distribution channels, further reduces our and our distributors' margins, or impacts our ability to offer

our services in new ways will likely mean the end of our business." McGlade WDT ¶ 58 (DiMA Tr. Ex. 5).

186. RealNetworks' Mr. Quirk echoed that testimony, adding that the Copyright Owners' proposed rates "would be fatal to my business." 2/26/08 Tr. 4638:13-17 (Quirk). "[I]f excessive costs are imposed on our business, we may be forced to abandon the market to Internet pirates." Quirk WDT ¶ 6 (DiMA Tr. Ex. 8). That result benefits no one, of course, because "both consumers and content creators will suffer." *Id.*; *see also id.* ¶ 46 ("If the royalty rate set through this proceeding is too high or we are forced to pay minimum fees, it would seriously cripple the industry's efforts to fight pirated music.").

187. Similarly, Mr. Sheeran of RealNetworks testified that "[i]ncreasing our costs will not only make these existing economics even more difficult, it also will make it harder for those of us who remain to continue to invest in innovations like new portable devices, new distribution channels, or creative marketing." Sheeran WRT ¶ 7 (DiMA Tr. Ex. 11). At trial, Mr. Sheeran stated simply, "It would be difficult for me to see, frankly how we ever get our music business to become profitable if [the Copyright Owners'] rates were adopted." 5/13/08 Tr. 6162:4-7 (Sheeran).

188. Rather than reward legal digital music distributors for their contributions, raising the rate would effectively subject them to a financial penalty, immediately discouraging innovative behavior going forward. Indeed, far from ensuring that legal digital distributors obtain a fair income in light of their relative contributions, an unduly high mechanical rate would stick them with unreasonably high costs. *See, e.g.,* Cue

WDT ¶ 52 (DiMA Tr. Ex. 3); McGlade WDT ¶ 58 (DiMA Tr. Ex. 5); Quirk WDT ¶ 6 (DiMA Tr. Ex. 8).

VI. NOTHING IN THE RECORD SUPPORTS THE COPYRIGHT OWNERS' ASSUMPTION THAT SONGWRITING WILL DECLINE IF RATES DO NOT RISE

189. The Copyright Owners justify their rate proposal on the assumption that an increase is necessary to preserve songwriters' incentive to write songs. *See, e.g., Written Direct Statement of National Music Publishers' Association, Inc., the Songwriters Guild of America and the Nashville Songwriters Association International* at 13-14, Docket No. 2006-3 CRB DPRA (Nov. 30, 2006) (hereinafter "CO Written Direct Statement") ("[I]ncreased rates will allow more and more songwriters to do what they do best: create musical works for the enjoyment of the public."). Dr. Landes, the Copyright Owners' primary economic expert, admitted that his economic analysis of the proposal rests on this assumption about songwriter behavior. *See* Landes WDT ¶ 32 (CO Tr. Ex. 22) (describing this as an "assumption"); *see also* Slottje WRT at 22 (RIAA Tr. Ex. 81) ("[O]ne of the maintained hypotheses of the Landes Report is the notion that songwriters will drop out of the songwriting industry if the mechanical rate isn't set at the rates the publishing industry has proposed and that he has endorsed. I counted at least 14 instances where Professor Landes repeats over and over again the notion that the rate must be sufficiently high so as to 'provide incentives to create music.'").

190. The problem with this critical assumption, however, is the complete absence of evidence to back it up. *See* 5/6/08 Tr. 4817:15-19 (Guerin Calvert) (noting the absence of any "analysis [linking] together the supply response of creative works to increments in income or an empirical estimate of that on a copyright-owner-by-copyright-owner basis."). Indeed, while acknowledging that he had unfettered access to

extensive music publisher data, Dr. Landes confirmed that: (1) he has no direct evidence that increasing the mechanical rate would increase the number of songs written, (2) he has no direct evidence that increasing the mechanical rate would result in higher quality songs being written, and (3) he has not performed any empirical analysis on either point. *See* 5/20/08 Tr. 7422:20-7426:19 (Landes). The Copyright Owners' other economic expert, Dr. Murphy, confirmed that he too had no evidence or empirical analysis demonstrating this assumed relationship between the level of the mechanical rate and songwriting. *See* 5/15/08 Tr. 6956:5-6957:9 (K. Murphy).

191. Other Copyright Owners witnesses also testified to the absolute lack of evidence that a lower rate (or any particular rate level) would lead to a shortage of songs or fewer songwriters. *See, e.g.,* 1/30/08 Tr. 804:16-805:1 (Galdston) (confirming lack of support for his assertion that songwriters will be forced to leave their careers if the mechanical rate is not increased); 1/30/08 Tr. 846:5-847:18 (Shaw) (confirming lack of empirical support, beyond stories from friends, for her assertion that songwriters will be forced to leave their careers if the mechanical rate is not increased); 2/12/08 Tr. 2667:9-2669:3 (Firth) (acknowledging, in response to questions from the Court, lack of data demonstrating whether the number of songwriters has changed due to mechanical royalty rates).

192. Record evidence of songwriters' personal experiences demonstrates the point. Phil Galdston testified that he generally writes "about twenty to thirty songs per year," and that he has written about the same number of songs each year since his career began in 1968, even as the mechanical rate has risen for stretches and remained flat for stretches. *See, e.g.,* Galdston WDT ¶¶ 10, 13 (CO Tr. Ex. 4) ("Over the years . . . the

number of songs I have been producing has remained fairly consistent."); 1/30/08 Tr. 810:5-811:8 (Galdston) (confirming that there has been no meaningful change in the number of songs he wrote as the mechanical rate stayed flat at 2 cents per song and then rose to 9 cents per song).

193. The Copyright Owners have also failed to present any evidence of a correlation between the mechanical rate and the number of songwriters. Indeed, the record evidence suggests that the number of songwriters has remained steady or even risen in recent years irrespective of the mechanical rate. *See, e.g.,* Slottje WRT at 22 (RIAA Tr. Ex. 81) (noting that ASCAP membership has grew by 14 percent from 2006 to 2007 even though the mechanical rate was steady at 9.1 cents). Moreover, the number of professional songwriter members of the Nashville Songwriters Association International has remained steady at approximately 550 for about 10 years. *See* RIAA Tr. Ex. 1 (NSAI membership data); *see also* 1/28/08 Tr. 267:15-269:15 (Bogard) (interpreting RIAA Trial Exhibit 1). Roger Faxon testified that "[e]ach year, hundreds of thousands of people attempt to write songs." Faxon WDT ¶ 42 (CO Tr. Ex. 3). In his live direct testimony, Mr. Faxon explained that, due to the "nature of the creative output," "[s]ongwriters write a lot of songs." 1/29/08 Tr. 420:21-421:6 (Faxon). Likewise, Irwin Robinson testified that there is a robust supply of songwriters; indeed, thousands of them compete to sign the limited number of agreements publishers can offer. *See* 1/31/08 Tr. 1012:22-1013:18 (Robinson).

194. The record indicates that songwriters are drawn to the profession for reasons wholly unrelated to financial remuneration. *See, e.g.,* Slottje WRT at 23 (RIAA Tr. Ex. 81) (explaining the forces other than monetary compensation that motivate

songwriters). Songwriter Victoria Shaw testified that "I love what I do. I have the best job in the world. . . . It's a wonderful job. I love my job." 1/30/08 Tr. 824:7-18 (Shaw). Fellow songwriter Maia Sharp described her job as "soul satisfying," 1/31/08 Tr. 888:7-8 (Sharp), saying "I just love to write. It's my first love." *Id.* 868:19-20 (Sharp). Although Ms. Sharp earned only about eight thousand dollars for the first song she sold, recorded by Cher, "it was still a huge thrill to hear this voice I had heard for so many years singing a song that I had written. I was hooked on it." *Id.* 870:18-21 (Sharp). Ms. Sharp further explained that "songwriting is where my heart is." Sharp WDT ¶ 3 (CO Tr. Ex. 6). Thus, she testified, it is "not just a job for me; it is a career and a passion." *Id.* ¶ 14. Likewise, Stephen Paulus, a composer of operas, testified that he "did not become a composer to earn money." Paulus WDT ¶ 19 (CO Tr. Ex. 7). All of this evidence debunks the Copyright Owners' claims that decrease mechanical royalties will result in a concomitant decrease in the number or quality of songs.[11]

VII. THE RATE STRUCTURE ADOPTED FOR COMPULSORY MECHANICAL ROYALTY LICENSES WILL HAVE A PRONOUNCED IMPACT ON INDUSTRY PARTICIPANTS

195. One of the most critical tasks facing the Court is determining the appropriate structure for the mechanical rates at issue in this proceeding. The rate structure will have enormous and lasting implications for all industry participants as it bears on the alignment of interests between copyright owners and copyright users, and it impacts the ability of new enterprises to enter and existing providers to roll out new services. *See, e.g.,* Guerin-Calvert WRT ¶¶ 4, 16-17 (DiMA Tr. Ex. 10).

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[11] Moreover, as discussed above, *see supra* §§ III(B); IV(B), (C); V(C), lower mechanical rates for permanent downloads will facilitate new and innovative legitimate services, which in turn will lure customers from pirate websites, resulting in a higher overall revenue for a wider array of songwriters.

A. A Percentage-of-Revenue Structure Is Appropriate for Evolving Business Models and Widely Accepted in the Music Industry

196. The overwhelming weight of evidence presented during the hearings confirmed that a percentage-of-revenue methodology best achieves the statutory objectives as applied to permanent downloads. Indeed, while the Copyright Owners propose a penny rate, several of their witnesses testified that a percentage-rate methodology is most appropriate for nascent and evolving businesses – a description that even their chief economic expert applies to permanent download services. *See supra* ¶ 141.

197. As explained below, a percentage structure is superior to a penny rate because it (1) better aligns the interests of copyright owners and copyright users, (2) provides the flexibility necessary to introduce new and innovative features and services (thereby maximizing the availability of creative works to the public), and (3) eliminates the need for ongoing rate adjustments that attempt to track future changes in price. Percentage rates can encourage innovation, however, only if the rates are not set at unreasonably high levels, are not keyed to overly broad revenue bases, and are not accompanied by minima that impose effective pricing floors.

198. A percentage rate would not disrupt the operations of copyright owners; indeed, there is no dispute that music publishers have deep experience in conducting their operations under a percentage-rate system, as percentages are the norm for mechanical rates for digital products around the world.

1. A Percentage-of-Revenue Structure Is Appropriate for Nascent Evolving Business Models

199. A percentage-of-revenue approach is particularly appropriate for businesses that continue to evolve. *See supra* § V(A) (describing the evolving nature of

digital distribution models). As Ms. Guerin-Calvert explained, a percentage rate structure "is superior to a [penny rate] because it implicitly recognizes the need for royalty rate compensation based on a dynamic metric that reflects the dynamic nature of competition and industry structure." Guerin-Calvert WRT ¶ 4 (DiMA Tr. Ex. 10); *see also* Teece WDT at 5 (RIAA Tr. Ex. 64) ("Under conditions of uncertainty, a percentage rate is beneficial. A percentage rate would automatically accommodate such uncertainty.").

200. The Copyright Owners' primary expert economist shares this view. Dr. Landes confirmed that a percentage rate is appropriate where business models are evolving, *see* 2/11/08 Tr. 2549:15-20 (Landes), and he acknowledged that digital distribution – including permanent download services – remains an evolving business. *See* 2/11/08 Tr. 2550:2-19, 2551:4-19 (Landes).

201. Geoffrey Taylor, General Counsel and Executive Vice-President of IFPI, concurred, noting that "[p]ercentage rate structures are prevalent around the world because they provide a flexible and sensible method for determining appropriate mechanical royalties in changing and diverse marketplaces." Taylor WDT at 4 (RIAA Tr. Ex. 53). A percentage rate "accommodates changes in price, technology, business model, and other marketplace characteristics by preserving the balance" between mechanical rates and revenues, "without having to specifically address variations in pricing among different types of products and services." *Id.*; *see also* Boulton WDT ¶ 3.12 (RIAA Tr. Ex. 54).

202. Mr. Taylor also explained that "[p]ercentage royalties also accommodate flexible pricing so as to maximize sales, such as marketing older catalog recordings at reduced prices, which creates incentives for record companies to continue distribution of

recordings that otherwise might not generate mechanical income for their writers and publishers." Taylor WDT at 4-5 (RIAA Tr. Ex. 53). Indeed, Mr. Taylor expressed his belief at trial that the flexibility that a percentage rate affords has "helped contribute to the fact that there are more records bought per head of population in the UK than anywhere else in the world." 2/12/08 Tr. 2738:5-9 (Taylor).

203. Likewise, Dr. David Teece testified that "a percentage royalty rate regime would allow the recording industry to test innovative business models involving lower price point products where doing so will result in more sales and profit." Teece WDT at 5 (RIAA Tr. Ex. 64); *see also* Slottje WRT at 18 (RIAA Tr. Ex. 81) ("Flexibility in the mechanical rate is of high importance in order to maintain a workable framework for all of the stakeholders in the music business, not just the publishers and songwriters, and to allow record companies to take the risks necessary to keep 'growing the pie' in a way that benefits both record companies and music publishers."). As a result, "songs that otherwise would not have been available to the public and which would have produced no income for their writers or publishers, will have a chance to earn mechanical royalties." Teece WDT at 5 (RIAA Tr. Ex. 64).

2. A Percentage-of-Revenue Structure Aligns Interests

204. A percentage rate is the superior methodology for calculating royalty payments in an intellectual property context like this one because it reflects the direct link between copyright holders and copyright users, and produces a shared interest in selling more legal works to the public. *See, e.g.,* Guerin-Calvert WDT ¶ 16(1) (DiMA Tr. Ex. 7) ("A percentage of revenue structure provides a mechanism to allow for copyright users and owners to share in the actual gains from expansion of digital sales, while allowing for a cost structure that promotes such expansion and financial viability."); *id.* ¶ 120(1);

Teece WDT at 5 (RIAA Tr. Ex. 64) ("A percentage rate would more closely align the economic incentives of the parties so that the record companies' incentive to increase profits would be expected to protect the publishers' interests."); *id.* at 71 ("If mechanical royalties are set on a percentage basis, then the economic interests of songwriters/publishers on the one hand, and record companies, on the other are aligned with one another to significant degree. The same pricing decisions that serve the interests of the record companies also tend to serve the interests of the songwriter/publishers.") (emphasis in original); Taylor WDT at 5 (RIAA Tr. Ex. 53) (noting that a percentage rate ensures fairness by "protecting record companies [and digital distributors] against unfairly high mechanical royalties if prices fall, while at the same time allowing songwriters to benefit from higher prices").

205. Richard Boulton, the RIAA's expert in the economics of licensing rights of music in the United Kingdom, *see* 2/12/08 Tr. 2892:2-17, explained this virtue of the percentage structure as follows:

> [A] revenue-based royalty is appropriate for permanent downloads . . . because there is a clear link between the contribution of the licensor and the revenues generated by the licensee. In these circumstances, the revenue share incentivises the licensor to increase the value of its inputs.

Boulton WDT ¶ 3.11 (RIAA Tr. Ex. 54); *see also* 2/13/08 Tr. 2992:14-2993:2 (Boulton).

206. Asked by the Court to further explain the "clear link," Mr. Boulton noted that "the contribution made by the copyright [owner], in this case in the copy of the sound recording, can't be separated from the products that are being sold." 2/13/08 Tr. 2993:7-10 (Boulton). As a result, he explained, "the contribution that the copyright owner is making to the revenues that are earned by the music service provider is such that they have a commonality of interest." *Id.* 2993:11-15 (Boulton). He noted that a

percentage-of-revenue structure is valuable because it "align[s] the interests of the copyright owner and the licensee in maximizing [the work's] success in the marketplace," thereby "reinforce[ing] that common interest." *Id.* 2994:5-8, 2996:7-13 (Boulton); *see also* 2/13/08 Tr. 3152:2-19 (C. Finkelstein) (testifying that a percentage rate is superior to a penny rate because it compels copyright owners and copyright users to "walk forward together" in the face of the piracy threat, and because it affords the flexibility necessary to compete with pirate services).

3. A Percentage-of-Revenue Structure Eliminates the Need for Ongoing Rate Adjustments to Attempt to Track Changing Prices

207. A percentage rate is also superior to a penny rate because it "effectively adjusts over time." Guerin-Calvert WDT ¶ 16(1) (DiMA Tr. Ex. 7); *id.* ¶ 120(1); Teece WDT at 5, 70 (RIAA Tr. Ex. 64). Thus, a percentage methodology would relieve the Court of determining how best to tweak a per-unit penny rate to attempt to reflect inflation and price adjustments over time. *See, e.g.,* Guerin-Calvert WRT ¶ 17 (DiMA Tr. Ex. 10) ("A percent of revenue royalty structure eliminates the need for inflation adjustment since the copyright owner and user would share equally in the upside and downside adjustments in the final downstream product pricing."); Boulton WDT ¶ 3.12 (RIAA Tr. Ex. 54) ("A revenue-based royalty requires less frequent review since it responds to changes in price and volumes whereas a quantity-based royalty responds only to changes in volumes."); Teece WDT at 70-71 (RIAA Tr. Ex. 64) ("With a percentage-based royalty, we don't need to accurately forecast the future as the fortunes of all will ride with the market. Hence a percentage royalty not only provides more pricing flexibility; amounts paid automatically adapt to changing industry circumstances and product pricing changes that occur in response to market condition changes."); Slottje

WRT at 18 (RIAA Tr. Ex. 81) ("[B]ecause a percent rate is inflation neutral, it not only is fair to both parties in time of inflationary pressure or deflation, but eliminates the need to adjust the rate frequently in a time of inflation, which lowers overall transaction costs.").

208. This virtue is important, Ms. Guerin-Calvert explained, because tweaks designed to account for inflation would produce an unearned windfall for copyright owners in the likely event that copyright users are unable to increase their prices quickly enough to keep up with inflation. *See* Guerin-Calvert WRT ¶ 16 (DiMA Tr. Ex. 10) ("[T]here is no indication that copyright users will be able to offset [penny-rate] increases [designed to track inflation] with price increases to the consumer given current and likely future market conditions."); *see also infra* § VIII(B)(2) (describing the flaws with the Copyright Owners' proposal to adjust their proposed rates in concert with CPI fluctuations).

4. Music Publishers Are Familiar with Percentage Rates

209. Music publishers already employ percentage-of-revenue methodologies for non-mechanical royalty payments in the United States and for a variety of royalty payments (including mechanical payments) elsewhere around the world. Mr. Faxon, for instance, acknowledged that EMI Music Publishing uses a percentage-of-revenue structure "routinely" for digital music. *See* 1/30/08 Tr. 680:22-681:5 (Faxon). He also confirmed that EMI Music Publishing earns mechanical royalties as a percentage of revenue in other countries, *see id.* 682:8-11 (Faxon), that it receives performance royalties for digital music from ASCAP and BMI as a percentage of revenue, *see id.* 686:4-7 (Faxon), and that its voluntary digital licensing agreements, including ringtone agreements and new digital media agreements, call for royalty payments calculated as a percentage of revenue coupled with a penny minimum. *See id.* 687:13-688:2 (Faxon).

Mr. Faxon also acknowledged that music publishers have accounting systems in place to process and distribute royalties calculated on the basis of a percentage of revenue. *See id.* 684:14-19 (Faxon). Because copyright owners already employ percentage-of-revenue systems in a variety of royalty contexts, applying percentage rates in this proceeding would not result in the disruptions about which the Copyright Owners have speculated.

210. Mr. Faxon further testified that there is no reason not to employ a percentage rate for digital products. *See* 1/29/08 Tr. 485:11-22 (Faxon). While he noted that existing agreements with songwriters would make it difficult to use a percentage rate for physical products, he testified that there are no comparable agreements in place with respect to digital products. *See id.* 482:22-483:3 (Faxon) (adopting a percentage rate for digital products would not require EMI Music Publishing to renegotiate arrangements with songwriters). Indeed, he stated that "we do not think it will be disruptive to have a percentage with a minima" for digital products, because "that is the way we constructed most of . . . EMI's on-line . . . and digital agreements." *Id.* 482:15-20 (Faxon) (emphasis supplied); *see also* Faxon WDT ¶ 75 (CO Tr. Ex. 3) (explaining that EMI's current agreements with songwriters are premised on the existence of a penny rate only for physical products); *see also* 1/29/08 Tr. 479:2-7 (Faxon) (same).

211. Phil Galdston, a songwriter with thirty years of experience in the industry, likewise recognized the value of a percentage-based royalty structure. *See* 1/30/08 Tr. 806:14-807:18 (Galdston). Mr. Galdston testified that the current penny rate subjects him to a static royalty for every unit sold while labels can price flexibly to achieve greater returns per unit. *See* Galdston WDT ¶ 12 (CO Tr. Ex. 4); 1/30/08 Tr. 806:14-18 (Galdston). He acknowledged that a percentage-of-revenue methodology could in

principle address that revenue imbalance. *See* 1/30/08 Tr. 806:19-807:18 (Galdston); *see also* 2/26/08 Tr. 4621:9-4622:2 (Quirk) ("[I]n my own experience as a songwriter and musician[,] a percentage of revenue model works . . . .").

5. Percentage Rates Are the Norm Around the World

212. The record reveals that percentage rates are the norm for mechanical royalty payment structures for digital music distribution around the world. Indeed, the United States is "one of the only countries in the world not to use a percentage royalty structure for mechanical licensing," as "almost every country in the world has recognized the advantages" of a percentage rate. Taylor WDT at 1, 4 (RIAA Ex. 53). This fact thoroughly undermines the Copyright Owners' assertion that applying a percentage rate in this country would result in severe disruption.

213. The Copyright Owners' own witnesses testified about the prevalence of percentage-based mechanical royalty systems for digital music around the world. Jeremy Fabinyi, the Managing Director of Mechanicals at the MCPS-PRS Alliance, offered detailed testimony in this regard. In particular, in attachment F-2 to his written rebuttal statement, Mr. Fabinyi identified the mechanical royalty rate for permanent downloads in each of sixteen countries (thirteen European countries, Japan, Canada, and the United States). *See* Fabinyi WRT, attach. F-2 (CO Tr. Ex. 380).[12] With the lone exception of the United States, each of the countries Mr. Fabinyi identified calculates mechanical royalties as a percentage of revenue. *See id.*[13]

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[12] The second column in attachment F-2, which identifies retail pricing in the listed countries, confirms that Mr. Fabinyi's rate data relate to permanent downloads. *See* Fabinyi WRT, attach. F-2 (CO Tr. Ex. 380).

[13] While Mr. Fabinyi noted that at least some of these countries employ a minimum royalty in addition to the percentage rate, the minima are "true minima" in the sense

214. Mr. Fabinyi testified that every European Union country employs a percentage rate, not a penny rate, for mechanical royalties for digital music. *See* 5/15/08 Tr. 6825:7-14 (Fabinyi). He also testified that he not aware of any country anywhere in the world other than the United States uses a method other than a percentage-rate structure to calculate mechanical royalties for downloads. *See id.* 6827:4-9 (Fabinyi). Ralph Peer also testified that "in most countries, other than the United States, [Peermusic] receives payment of mechanical royalties calculated on a percentage basis." 2/5/2008 Tr. 1678:20-1679:2 (Peer). In light of this evidence presented by their own witness, it defies reason for the Copyright Owners to argue that adopting the practice they already use around the world would disrupt the industry.

215. Other witnesses confirmed that the United States is the exception rather than the rule when it comes to the mechanical royalty methodology for digital music downloads. Geoffrey Taylor, for instance, testified that "[t]he United States is . . . one of the only countries in the world not to use percentage royalty structure for mechanical licensing," Taylor WDT at 1 (RIAA Tr. Ex. 53), and Dr. David Teece noted that "the vast majority of countries around the world with mechanical royalties systems calculate the royalty on a percentage of revenue basis." Teece WDT at 69 (RIAA Tr. Ex. 64).

6. A Percentage Rate Can Encourage Ongoing Innovation and Marketplace Expansion Only If It Is Not Unreasonably High

216. The chief virtue of a percentage rate is that, unlike a penny rate, *see infra* § VII(B), it does not stifle the technological investment and innovation critical to the future health of the music industry. *See supra* §§ III(B); V(C). But this advantage will

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that the revenue-based approach generates greater royalty payments under current industry pricing levels. *See* 5/15/08 Tr. 6851:18-6852:5 (Fabinyi).

be realized only if the percentage rate is not set so high (or accompanied by unreasonably high "minima") that it discourages technological experimentation. *See* Guerin-Calvert WRT ¶¶ 4, 29, 32 (DiMA Tr. Ex. 10).

217. In this industry, "new technologies have the potential dramatically to expand the scope of individuals that can easily access royalty bearing works, but require new and risky investments subject to downstream pricing constraints." *Id.* ¶ 32. "In such circumstances," Ms. Guerin-Calvert explained, "royalty rates that are set too high could deter output expansion (and royalty expansion) activity." *Id.*; *see also id.* ¶ 4 ("[A]ny increase in the proposed percent of revenue rate above DiMA's initial recommended rates should be very carefully evaluated with regard to the effects on entrants and expanding firms."). "In the digital industry, unlike in the 1980s, setting royalty rates too high runs the risk of substantially reducing the expected volume of music purchased. Given the very high fixed costs, the importance of continued and expanded marketing, and the price sensitivity of customers due to piracy, higher royalty rates risk financial imbalance for digital media companies." Guerin-Calvert WDT ¶ 113 (DiMA Tr. Ex. 7).

218. The impact on potential new entrants into the digital downloading business – entities not represented in this proceeding – reinforces the importance of adopting a rate low enough to encourage the expansion and innovation on which the future of the recorded music industry depends. DiMA's second amended rate proposal for digital downloads, described in detail below, *see infra* § VIII(A), "reflect[s] the appropriate industry-wide rate covering not just incumbents but also firms that would enter de novo or would consider introducing new business models." Guerin-Calvert WRT ¶ 29 (DiMA Tr. Ex. 10). But the proposal is "at the highest end of the range . . .

223. Because of the possibility of severely negative impacts – particularly with respect to new and evolving business lines – "imposing any minima in this developing and evolving marketplace" requires the exercise of caution. *Id.* ¶ 4. To this end, any minima adopted in this proceeding "should be set at a level that would not deter entry or innovative business models that would encourage access and maximization of music distribution, which ultimately benefits copyright owners in the long run." *Id.* ¶ 35.

B. A Penny Rate Would Disrupt Innovation and Technological Investment, Discourage New Entry into the Digital Distribution Industry, and Limit Availability of Music to the Public

224. In contrast to the varied benefits of a percentage structure, a penny rate suffers from a host of flaws, most notably its inflexibility. Because a penny rate imposes a static cost on copyright users regardless of the price at which they can successfully offer their services, it serves as a fixed limit on legal digital music distributors' ability to use aggressive pricing to entice consumers to try new offerings or particular tracks. *See, e.g.*, A. Finkelstein WRT at 5 (RIAA Tr. Ex. 84) (penny rates and penny minima "are insensitive to price" and when prices fall they "make lower-price uses uneconomical . . . prevent[ing] writers and publishers from realizing income from those uses.").

225. The impact would be most harmful for new digital music distributors and for existing businesses introducing new products, as both must price aggressively to entice consumers. To be sure, the iTunes Store launched under a penny-rate system and has achieved great success. *See supra* § VIII(A)(4). But its success is noteworthy in large part because it is unique; the absence of comparable success stories demonstrates that a penny-rate structure does not serve the statutory objective of promoting entry.

226. By injecting an inflexible cost into these operations, a penny rate discourages new entrants and existing participants from making the technological

investments necessary to expand the marketplace and increase revenues for all legal participants in the recorded music industry. *See, e.g.,* Teece WDT at 72 (RIAA Tr. Ex. 64) ("[U]under fixed cents-per-tune regime, the record companies may be foreclosed from introducing low price point products that would benefit the record companies and the songwriters/music publishers. Such products could be pursued under percentage royalty regime.").

227. Similarly, a penny rate suffers from the fact that it "assumes that the value per work is fixed across all works and can precisely and accurately be estimated." Guerin-Calvert WRT ¶ 34 n.31 (DiMA Tr. Ex. 10). The revenue generated by the sale of a work is dictated by market conditions, however, *see* K. Murphy WRT ¶ 11 (CO Tr. Ex. 400) ("[T]he economic value of the required creation and distribution inputs derives from the value that consumers place on the final product."), and the inclusion of a fixed penny rate injects a rigid cost component into a dynamic product development and pricing calculus that otherwise adjusts to reflect supply and demand. *See* 5/19/08 Tr. 7016:13-16 (K. Murphy) (confirming that a penny rate does not account for changes in market values over time).

228. While a percentage rate automatically adjusts the apportionment between copyright holders and users alongside changes in revenue, a penny rate remains fixed regardless of marketplace dynamics. In this regard, the Chief Financial Officer of EMI North America testified that a fixed penny rate "has a very negative impact" because "it doesn't respond to what's actually happening in the marketplace." 2/13/08 Tr. 3146:10-14 (C. Finkelstein). As explained above, this can lead to harmful results for copyright users. It can also harm copyright owners, however: "with a fixed cents-per-tune royalty,

the songwriter/music publishers do not share in any of the benefits of an increase in the price of sound recordings (CDs or downloads)." Teece WDT at 72 (RIAA Tr. Ex. 64) (emphasis in original); *see also* 1/30/08 Tr. 806:14-807:18 (Galdston) (noting that a penny rate creates a revenue imbalance, and recognizing that a percentage rate could allow songwriters to share in record companies' ability to achieve greater returns through pricing flexibly).

VIII. THE PARTIES' RATE PROPOSALS

229. As described in further detail below, copyright users and copyright owners have proposed diametrically different rates and terms. DiMA proposes a percentage rate with minimum fees that provide true downside protection. The Copyright Owners propose an unprecedented and unjustifiable increase to the existing penny rate. DiMA's proposal is calculated to achieve the statutory objectives and grasp the opportunity to expand revenues in the one subsector (digital music) with the potential for growth. *See infra* § X. The Copyright Owners' proposal grabs a few more pennies for each copy sold but sacrifices new entry and growth of the marketplace.

A. DiMA's Second Amended Proposed Rates and Terms

230. DiMA amended its proposal before the rebuttal phase of the proceeding in an effort to resolve legitimate concerns that were presented during the direct phase of the trial, including concerns about defining the revenue base to which a percentage rate would apply and concerns about ensuring fair compensation to copyright owners while permitting digital distributors to experiment with lower prices or experiment with bundled product offerings.[14] DiMA's second amended rate proposal for permanent

[14] DiMA amended its proposal for a second time on July 2, 2008, to remove proposed rates and terms associated with products and services covered by the partial

downloads calls for the greater of (i) 6 percent of applicable receipts, or (ii) 4.8 cents per track for single tracks or 3.3 cents per track for tracks sold as part of a single transaction including more than a single track (*i.e.*, bundles). *See* DiMA Second Amended Proposal § 380.3(a).

1. DiMA's Second Amended Proposed Rate and Rate Structure Achieves the Statutory Objectives

231. DiMA's second amended proposed rates and terms achieve the statutory objectives. *See* Guerin-Calvert WDT ¶¶ 4, 10, 97 (DiMA Tr. Ex. 7). Most importantly, business models for digital distribution are still nascent and evolving, with high costs and risks, and require consumers to pay for something that is otherwise available for free at the click of a button. *See id.* ¶¶ 10, 11, 102-105. In this environment, legitimate digital distribution, innovation and new entry have the potential to expand revenues for the entire industry, as long as digital distributors are not saddled with unreasonable costs. *See id.* ¶¶ 12, 15, 99-101, 106.

232. Under these conditions, Ms. Guerin-Calvert testified that rates should be sufficiently flexible to support a variety of business models and to account for the uncertainties and risks associated with digital distribution's evolution. *See id.* ¶ 15. A percentage-of-revenue structure is therefore the required foundation for a reasonable rate, *see id.* ¶¶ 16(1), 120(1), applied to a revenue base that captures revenues from the sale of music but not from revenue that is "adjacent but not directly related." *Id.* ¶ 16(2); *see also id.* ¶¶ 115, 120(2).

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settlement agreement among the parties. A copy of DiMA's Second Amended Proposed Rates and Terms is attached as Appendix A.

233. Ms. Guerin-Calvert also testified that "setting a rate at a level appropriate for achieving a fair income for the copyright holders while achieving the other three objectives suggests that a rate in the 4% to 6% of retail revenue range, most appropriately at the lower end of that range, would better achieve the four objectives." Guerin-Calvert WDT ¶ 16(3) (DiMA Tr. Ex. 7); *see also id.* ¶ 120(3). She arrived at this recommendation based on her review of marketplace evidence about digital distribution of music in light of the statutory objectives. *See id.* ¶¶ 7, 20, 23-26, 114, 119, App. on U.K. Agreements.

234. In particular, she found that the rates most recently agreed to in the United Kingdom are the most appropriate comparable, but as an upper bound. *See id.* ¶ 26 n.16 ("The arrangements included provisions for royalty rates for a bundle of rights broader than those under consideration in this proceeding."); *id.* App. on U.K. Agreements ¶ 3 (concluding that the rates in the U.K. agreements appropriately serve as ceiling). While relying principally on the Copyright Royalty Tribunal's 1981 determination for guidance as to the application of the statutory objectives, she derived further support for the reasonableness of her approach by converting the 1981 outcome to a percentage of retail revenue, which she found to be consistent with the U.K. outcome. *See id.* ¶ 120(3) n.80. To achieve the statutory objectives, she recommended a downward adjustment from the 5 to 8 percent range suggested by the U.K. agreement and the 1981 determination. *See id.* ¶¶ 16(3), 120(3); *see also id.* ¶ 113 (lower rates have greater probability of achieving the statutory objectives). Empirical testing of rates in the 4 to 6 percent range confirmed they would provide "substantial returns to copyright owners and adequate compensation to the industry participants." *Id.* ¶ 16(4); *see also* ¶ 121.

235. Ms. Guerin-Calvert testified that a rate meeting these criteria "satisfies the four objectives by providing fair compensation and adequate returns and maximization of creative works with the least potential for disruption in the industry." *Id.* ¶ 17. She concluded in her written direct testimony that DiMA's original proposal was "consistent with the[se] principles." *Id.* And, after DiMA amended its proposal prior to the rebuttal phase of the hearing, Ms. Guerin-Calvert concluded in her written rebuttal testimony that "DiMA's amended rates reflect the appropriate industry-wide rate covering not just incumbents but also firms that would enter de novo or would consider introducing new business models." Guerin-Calvert WRT ¶ 29 (DiMA Tr. Ex. 10). She explained further, however, that DiMA's amended proposed rates "are at the highest end of the range that I would independently justify as consistent with the statutory objectives," *id.*, and she urged the Court to exercise great caution in adopting any minima. *See id.* ¶¶ 33-35.

236. Moreover, although minima may be of some value, they must be determined with care to avoid stifling innovation and technological investment. *See supra* § VII(A)(8). Prices are under severe downward pressure. *See supra* §§ III(A)(2), V(D). DiMA's proposed minima "recognize that business models are evolving." Sheeran WRT ¶ 28 (DiMA Tr. Ex. 11). In addition, "DiMA's proposed minima specifically recognizes that the minima must be lower for permanent downloads that are sold as part of a bundle, to accommodate the industry-standard practice of providing a discounted 'album' price (i.e. in a service where permanent downloads sell for $0.99, an album with 15 tracks might sell for $9.99)." Sheeran WRT ¶ 28 (DiMA Tr. Ex. 11).

2. DiMA's Proposed Definition of Revenue Is Reasonable

237. DiMA's second amended proposed rates and terms include a definition of the revenue base – described as "applicable receipts" – against which its proposed

percentage rates would apply. *See* DiMA Second Amended Proposal § 380.2(a). Under DiMA's proposed definition, "applicable receipts" include (1) revenue recognized by the licensee from residents of the United States in consideration for a digital phonorecord delivery and (2) the licensee's advertising revenues attributable to third-party advertising "in download" – namely, advertising placed immediately at the start, end or during the actual delivery of a digital phonorecord, less advertising agency and sales commissions. *See* DiMA Second Amended Proposal § 380.2(a). The proposed definition of "applicable receipts" also includes the same categories of payments when made to a parent, majority-owned subsidiary or division of the licensee. *Id.*

238. The proposed definition of "applicable receipts" in DiMA's second amended proposal excludes revenues that are not directly attributable to the sale of music. More specifically, the proposed definition excludes "(i) revenues attributable to the sale and/or license of equipment and/or technology, including bandwidth, including but not limited to sales of devices that receive or perform the licensee's digital phonorecord deliveries and any taxes, shipping and handling fees therefore; (ii) royalties paid to the licensee for intellectual property rights; (iii) sales and use taxes, shipping and handling, credit card and fulfillment service fees paid to third parties; (iv) bad debt expense; and (v) advertising revenues other than" the in-download revenues included in applicable receipts as described above. *Id.* § 380.2(a)(3).

239. Generally speaking, DiMA's proposed definition of applicable receipts includes only revenues directly attributable to the sale of the copyrighted works. *See id.* § 380.2(a); *see also* 2/26/08 Tr. 4626:1-4627:10 (Quirk) (explaining the proposed revenue definition); Sheeran WRT ¶ 26 (DiMA Tr. Ex. 11) (explaining the proposed

revenue definition). As Ms. Guerin-Calvert testified, "revenue attributable to use of the work represent[s] the single economic variable that captured well the economic growth potential and hence compensation and that linked the two sides of the market together." Guerin-Calvert WDT ¶ 114 (DiMA Tr. Ex. 7). DiMA's proposed definition embodies that virtue, and it therefore "has the greatest potential to provide increased compensation as the marketplace expands and to deliver this to the copyright holder." *Id.*; *cf. supra* § VIII(A)(7) (explaining the importance of avoiding an overly broad revenue base).

3. DiMA's Other Proposed Terms Allow for Proper Application of Its Proposed Rates

240. DiMA's second amended proposal also includes the terms necessary to apply its proposed rates. Most importantly, DiMA's second amended proposal expressly provides that a compulsory license issued under Section 115 extends to, and includes full payment for, all reproductions necessary to engage in activities covered by the license, including but not limited to: (a) the making of reproductions by and for end users; and (b) all reproductions made in the normal course of engaging in such activities, including but not limited to masters, reproductions on servers, cached, network, and buffer reproductions. *See* DiMA Second Amended Proposal § 380.4; *see also* Sheeran WRT ¶ 22 (DiMA Tr. Ex. 11).

241. This is essential because, as Mr. Sheeran explained, "a license to make and distribute digital phonorecord deliveries without coverage of all copies that are necessary and part of the distribution is unusable and practically worthless." Sheeran WRT ¶ 24 (DiMA Tr. Ex. 11). Just as "in an earlier era, it was understood that a single mechanical license covered the entire process of bringing vinyl records to market, including any intermediate reproductions made in order to press the final records," it is

"common sense that the entire chain of reproduction and distribution activities needed to bring music to the customer" should be covered by the license for digital music as well. A. Finkelstein WDT at 17 (RIAA Tr. Ex. 61); *see also* Guerin-Calvert WRT ¶ 44 DiMA Ex 10 (all copies that are "necessary to engage in the activity of making and distributing phonorecords by digital transmission, for which a mechanical rate is being set under the statute" should be included in the license).

242. DiMA's proposed terms also provide for distribution of digital music by a "licensee" or a "licensee's carriers." *See* DiMA Second Amended Proposal § 380.2(d), (e). These terms are important as they would minimize disruption to existing business arrangements that allow the distribution of downloads through distribution partners. *See* McGlade WDT ¶¶ 6-7 (DiMA Tr. Ex. 5).

243. In addition, DiMA's second amended proposal defines "digital phonorecord delivery" as that term is defined in Section 115(d) of the Copyright Act, and it defines "permanent digital phonorecord delivery" as a digital phonorecord delivery that is distributed in the form of a download that may be retained and played on a permanent basis. *See* DiMA Second Amended Proposal § 380.2(b), (c). It defines "licensed work" as the nondramatic musical work embodied or intended to be embodied in a digital phonorecord delivery made under the compulsory license. *See id.* § 380.2(d).

4. DiMA's Proposal Applies to the Entire Industry, Not Just a Single Company

244. The rates and terms to be adopted in this proceeding will apply to an entire industry, including future entrants. Thus, DiMA's proposal is calculated to achieve the statutory objectives for all potential copyright owners and copyright users, not just those participating in the proceeding. In clear disregard of this principle, the Copyright

Owner's proposal focuses entirely on Apple and the iTunes Store. *See* 2/5/08 Tr. 1423:11-1425:10 (Israelite); 2/4/08 Tr. 1236:12-18 (Enders); 2/11/08 Tr. 2572:7-17 (Landes).

245. To be sure, Apple's iTunes Store represents an incredible success story in the face of perilous marketplace conditions and the economic straightjacket of the existing penny-rate system. No doubt it has also produced "substantial spillover benefits for the industry as a whole by increasing the interest and demand for digital music." Guerin-Calvert WDT ¶ 103 (DiMA Tr. Ex. 7); *see also* RIAA Tr. Ex. 51 at CO05006841 (Citigroup and JP Morgan, Investment Memorandum re BMG Music Publishing, June 2006) (recognizing that the improving environment for music is driven in part by success of iTunes). But there is no justification for calculating industry rates based on the track record of a single company. Indeed, the success of the iPod and the iTunes Store strongly support lower rates, not higher rates.

246. First of all, as explained above, *see supra* ¶¶ 69-70, Apple's success has come as a result of tremendous investment and risk-taking. Success was not inevitable. Raising the costs for new entrants would hinder comparable success in the future and would fail to achieve the statutory objectives. Whether Apple alone could sustain the rate hike proposed by the Copyright Owners is thus irrelevant to achieving the statutory objectives.

247. The Copyright Owners labored nonetheless to try to prove that Apple could withstand the dramatically higher penny rates they propose. In doing so, their witnesses conveniently assumed that Apple would continue to operate the iTunes Store notwithstanding steep reductions in its margins. *See* 2/11/08 Tr. 2576:17-19 (Landes). It

did not occur to Dr. Landes in particular to determine whether, at such lower margins, iTunes would provide a positive (or even zero) return on investment to Apple, whether iTunes' fixed costs would be recovered, whether Apple would continue to invest in and grow the business (considering, for example, alternative investment opportunities for Apple), and most importantly whether any entity not yet operating at iTunes' sales levels would stay in (or even enter) the business. *See id.* 2577:3-2578:17 (Landes). For the Copyright Owners, permanent download rates start and end with iTunes. *See id.* 2580:4-2581:5 (Landes); *see also id.* 2581:2-5 (Landes) (acknowledging that his analysis "doesn't say anything about Amazon or any other party that today or in the future may offer permanent downloads"). Their analysis is therefore flawed at its core.

248. Not only would setting a rate based on one company's business model or ability to pay higher rates fail to meet the statutory objectives, it would expose the entire emerging digital distribution industry to great hazard:

> Just as it would be economically inappropriate to determine the level of mechanical royalties on the basis of the most successful songwriter or publisher, it is similarly inappropriate to do so by focusing entirely on a single provider of digital music. Doing so introduces an unwarranted economic bias in a nascent marketplace towards perhaps just one or a few existing participants and against potential entrants or new business models.

See Guerin-Calvert WRT ¶ 8 (DiMA Tr. Ex. 10). To achieve the statutory objectives it is important to recognize that "the concurrent presence of different business models provides greater diversity for consumers and a variety of outlets for copyright holders." Guerin-Calvert WDT ¶ 103 (DiMA Tr. Ex. 7). "Royalties must be set using metrics that make the business model and type of access to creative works 'neutral' to encourage the variety and development of digital technologies to access creative works." *Id.* ¶ 112.

Setting rates that "tax" playback devices or ancillary business lines in general would in fact discourage new entrants, contrary to the statutory objectives. *See* 5/13/08 Tr. 6178:21-6179:14 (Sheeran).

249. Furthermore, there is no support for the Copyright Owners' contention that the rate for permanent downloads should be high to address the speculative fear that iTunes Store prices (alone among all competitors) are set artificially low so as to encourage the sales of iPods and iPod accessories. *See, e.g.,* Faxon WDT ¶ 50 (CO Tr. Ex. 3). iTunes prices were set when the iTunes Store launched based on undisputed marketplace conditions, not to subsidize iPods. *See id.* 4243:12-4244:5 (Cue) (citing CDs, piracy, and customer feedback as factors in pricing); 2/4/08 Tr. 1344:1-1345:21 (Enders) (digital downloads compete with CDs, which offer many relative advantages). Apple has always intended to run the iTunes Store as a profitable business. *See* 2/25/08 Tr. 4226:4-16 (Cue). And the Copyright Owners do not dispute that "the sale of tracks and albums through the iTunes Music Store has consistently generated a positive 'contribution margin' for Apple." Enders WDT at 30 (CO Tr. Ex. 10). Ms. Enders noted that the contribution margin from the iTunes Store "increased from 6.5 percent in calendar year 2002 to 17.6 percent in calendar year 2006," demonstrating that "Apple has enjoyed substantial and growing profits from the sale of music." *Id.* at 30-31. In fact, the iTunes Store has from the very beginning exceeded record label sales expectations, achieving in six days the level of sales the labels believed would be required to show a successful service after six months of operations. *See* 2/25/08 Tr. 4246:7-16 (Cue). This clearly is not an offering whose success is tied to hardware sales.

250. There is simply no evidence to support the Copyright Owners' argument that iTunes somehow subsidizes iPods. It is just as likely that iPods help to sell songs on iTunes and elsewhere. *See* 2/25/08 Tr. 4305:16-21 (Cue) (the ecosystem "works both ways."). Indeed, iPods were available to the public – and highly successful – well before the iTunes Store was launched. *See* 2/25/08 Tr. 4225:4-12, 4305:6-21 (Cue). And most iPods on average are used for much more than storing songs purchased from the iTunes Store. *See* 2/4/08 Tr. 1282:6-1283:1, 1286:4-10 (Enders) (the average iPod contains 22 to 27 songs acquired from iTunes). The success of the iPod has actually been a boon for the recorded music industry as it "has been a major factor behind a significant increase in download sales." Guerin-Calvert WDT ¶ 93 (DiMA Tr. Ex. 7).

B. The Copyright Owners' Proposed Rates and Terms

251. The Copyright Owners have proposed rates and terms focused on the zero-sum goal of dividing up a shrinking pie – and keeping the biggest piece for themselves. Nothing in the Copyright Owners proposal explains why higher rates and an inflexible penny-rate structure are the answer to falling prices in dynamic markets weighed down by rampant piracy. In short, the impact on digital distributors would be "tremendously negative" making it "difficult . . . to see . . . how [they] would ever . . . become profitable." 5/13/08 Tr. 6162:2-7 (Sheeran); *see also* 2/25/08 Tr. 4370:15-4371:1 (McGlade) (testifying that digital distribution with high fixed costs requires scale for profitability).

252. As Ms. Guerin-Calvert observed, "[t]here are two fundamental aspects to achieving the maximization of creative works – inducement to the composer to create the works (e.g., by increasing the number and diversity of artists and/or encouraging individual artists to be more prolific) and connecting the ultimate music consumer to the

broadest array of music." Guerin-Calvert WDT ¶ 109 (DiMA Tr. Ex. 7); *see also* Slottje WRT at 14-15 (RIAA Tr. Ex. 81) (explaining that the rate level impacts sales volumes, which directly affects copyright owners' revenues). The Copyright Owners' myopically high rate proposal completely disregards the second fundamental ingredient – connecting consumers to a broad array of music – by suggesting rates that would severely hobble existing digital music distributors and discourage others from entering the marketplace at all.

1. The Copyright Owners' Proposed Rate and Rate Structure Completely Fail to Achieve the Statutory Objectives

253. For permanent downloads, the Copyright Owners propose maintaining the current, inflexible penny-rate structure and increasing it by nearly 65 percent to 15 cents per song (or, if greater, to 2.90 cents per minute of playing time or fraction thereof). *See* CO Written Direct Statement at 11. They also propose adjusting the rate periodically to track changes to the Consumer Price Index. *See id.* In effect, this proposal would "impose a minimum rate of 15 cents per track on permanent downloads." *See* Sheeran WRT ¶ 9 (DiMA Tr. Ex. 11). It exceeds the rate they propose for physical phonorecords. *See* CO Written Direct Statement at 11 (proposing a rate of 12.5 cents per song for physical phonorecords).

254. The Copyright Owners' proposed rate for permanent downloads would cut digital distributors' gross margins by 40 percent, assuming stable prices. *See* 5/13/08 Tr. 6162:14-6163:15 (Sheeran). Since prices are actually falling, the impact would likely be even more severe. *See id.* 6164:1-19 (Sheeran). For iTunes, the choice would be whether to pass along the cost increase to consumers and threaten growth of the service or absorb any costs that could not be passed on to the labels. *See* 2/25/08 Tr. 4269:2-11,

4269:20-4270:5 (Cue). Apple would then have to question whether it "really want[s] to be in [the] business and [if so] what kind of ongoing investments" it would make. *Id.* 4271:3-8 (Cue); *see also id.* 4270:17-21 (Cue) (comparing Apple's overall margin "in the high 20s" with iTunes' margin "in the teens").

255. A parade of Copyright Owner witnesses attempted to justify the rate hike by observing that consumers place a higher value on music in digital format. *See, e.g.,* Faxon WDT ¶ 48 (CO Tr. Ex. 3) (explaining that the advanced technological features of legal digital music distribution "increase . . . the value of music to consumers"). But while digital phonorecords do create additional value for consumers, that value is not added by copyright owners. Peer WDT ¶ 47 (CO Tr. Ex. 13) ("[b]roadly speaking, the role of the publisher is the same online as it is offline."); *see also* Faxon WDT ¶ 36 (CO Tr. Ex. 3) (publishers perform "essentially the same [functions] in both the on-line and off-line worlds"); 1/29/08 Tr. 412:8-11 (Faxon) (EMI Music Publishing plays the same role with respect to digital and physical products); 1/31/08 Tr. 1087:6-1088:16 (Robinson) (same for The Famous Music Publishing Companies). Indeed, Irwin Robinson acknowledged that music publishers have not developed the features – or borne the corresponding costs – that make digital music attractive to customers. *See id.* 1086:6-1088:16 (Robinson).

256. Legitimate digital distributors are the source of the added value. As explained in great detail above, legal digital distributors (not copyright owners) have developed a wide array of consumer-friendly features and enhancements that continue to attract more and more consumers. *See supra* § IV(A). Dr. Landes acknowledged this point, testifying that "[n]ew [distribution] technologies . . . tend to increase the value of

and hence the demand for the underlying musical works, both new and old." Landes WDT ¶ 37 (CO Tr. Ex. 22).

257. Since the increased value of digital music derives from legitimate digital distribution – and not from anything that copyright owners contribute, *see, e.g.,* Peer WDT ¶ 47 (CO Tr. Ex. 13) (noting that copyright owners do not do anything differently in the digital and physical contexts); Faxon WDT ¶ 36 (CO Tr. Ex. 3) (same) – there is no reason to reward copyright owners and punish digital music distributors. Placing a higher rate on digital downloads than on physical phonorecords, as the Copyright Owners suggest, fails to reflect accurately the relative contributions of copyright owners and copyright users, as measured by technological innovation, investments, risk and opening of new markets.

258. In a particularly perverse application of the laws of supply and demand, several Copyright Owner witnesses justified the proposed 65 percent rate increase on the ground that sales are dropping. *See, e.g.,* Faxon WDT ¶ 45 (CO Tr. Ex. 3); Peer WDT ¶¶ 53-54 (CO Tr. Ex. 13); Israelite WDT ¶¶ 25-26 (CO Tr. Ex. 11); 1/31/08 Tr. 977:1-3 (Robinson) ("Q: So if you sell less, you think you should be paid more, right? A: Yes."). In other words, the Copyright Owners urge the Court to grant them more compensation at precisely the time – and even because – the overall revenue pie is shrinking. As explained above, this shortsighted focus would only serve to raise distribution costs and therefore further disrupt the industry by pushing more consumers to piracy. *See supra* ¶¶ 136-137. "Forcing a legitimate music service to price itself out of the market only results in more piracy activities, which harms both copyright owners and users . . . ." McGlade WDT ¶ 58 (DiMA Tr. Ex. 5).

2. The Requested CPI Adjustment Is Similarly Flawed

259. The Copyright Owners also propose adjusting their penny rate inflexibly over time to give them the benefit of any changes in the Consumer Price Index, regardless of conditions in the marketplace. *See* CO Written Direct Statement at 11-12. This adjustment would effectively ensure copyright owners "a constant royalty rate in real terms irrespective of whether copyright users are able to adjust the price of the final demand product by the same rate of inflation." Guerin-Calvert WRT ¶ 12 (DiMA Tr. Ex. 10). Indeed, the record evidence demonstrates that copyright users are not able to adjust their prices upward in keeping with inflation; to the contrary, severe pricing pressures have greatly restricted their ability to increase prices at all. *See id.* ¶ 16; *see also supra* § V(D).

260. Thus, a CPI-based adjustment mechanism suffers from a core flaw, as it shifts all the risk of inflation to copyright users that operate under intense downward pricing pressure:

> If the copyright user is able to raise price to cover inflation, then the copyright user will remain whole; however, if market conditions prevent the copyright user from raising downstream prices to keep up with the increase in input costs due to the indexed mechanical royalty rate, then the copyright user will be harmed.

Guerin-Calvert WRT ¶ 13 (DiMA Tr. Ex. 10); *see also* Sheeran WRT ¶ 12 (DiMA Tr. Ex. 11) ("[I]n order for the price adjustments to move with the CPI without the extra cost being borne by the service providers, retail prices would need to be able to move in conjunction with the CPI, which they have not ever done."). To the extent that copyright users are constrained in their ability to raise prices, a CPI-based adjustment "represents a transfer of wealth from the copyright user to the copyright owner." Guerin-Calvert WRT

¶ 16 (DiMA Tr. Ex. 10). For these reasons, the Copyright Owners' proposed CPI-based adjustment mechanism should be rejected.

3. Controlled Composition Clauses Are Irrelevant

261. Many of the Copyright Owners' witnesses justified their support for this unprecedentedly high rate proposal in large part based on the prevalence of controlled composition clauses. Victoria Shaw, for instance, voiced support for "[a]n increase in the mechanical rate" on the ground that record labels "are able to manipulate the royalty rate through controlled compositions so that songwriters and music publishers receive even less than the current rates allow." Shaw WDT ¶ 22 (CO Tr. Ex. 5); *see also* Galdston WDT ¶¶ 18, 20 (CO Tr. Ex. 4) (testifying that "[t]he expansion of controlled composition clauses has effectively undercut the mechanical rate" and, accordingly, that "an increase in the mechanical rate is warranted"); 1/30/08 Tr. 799:18-800:1 (Galdston) (supporting an increase in the mechanical rate because "songwriters have come under . . . a kind of assault . . . from the so-called three-quarter rate, the controlled composition rate"); Sharp WDT ¶¶ 19-21 (CO Tr. Ex. 6) (describing the hardships that result from controlled composition clauses and the need to raise the mechanical rate as a result); Faxon WDT ¶ 47 (CO Tr. Ex. 3).

262. For two reasons the impact of controlled composition clauses has no bearing on the Court's rate determination for permanent downloads. First, controlled composition clauses have virtually no bearing on digital music – and no impact whatsoever on music that might be licensed for digital distribution under the rates resulting from this proceeding. This is because the Digital Performance Right In Sound Recordings Act precludes controlled composition clauses from applying to most music licensed for digital distribution since June 1995. *See* Pub. L. No. 104-39, § 4, 109 Stat.

336, 344-49 (1995) (amending 17 U.S.C. § 115); *see also* 17 U.S.C. § 115(c)(3)(E) (amended provision). Indeed, Copyright Owner witnesses acknowledged that they are aware of this statutory limitation on the reach of controlled composition clauses. *See, e.g.,* Fabinyi WDT ¶ 5 n.1 (CO Tr. Ex. 380); 1/30/08 Tr. 644:22-645:2 (Faxon); 2/5/08 Tr. 1454:7-14 (Israelite); 2/12/08 Tr. 2712:22-2713:4 (Firth); 5/15/08 Tr. 6857:17-22 (Fabinyi).

263. The fact that these clauses have had no bearing on licensing of digital works since 1995 undercuts this justification for raising rates, especially since the justification was based on the increasingly "aggressive" use of controlled composition clauses after 1997. *See, e.g.,* 2/5/08 Tr. 1412:1-17, 1414:7-14:15-7 (Israelite) (stating that more aggressive use of controlled composition clauses since 1997 justifies an increase in the mechanical rate); *see also* Israelite WDT ¶¶ 25, 28 (CO Tr. Ex. 11) (testifying that a rate set in 1997 no longer adequately compensates Copyright Owners because "the statutory rate has become a frequently unobtainable ceiling" because of the subsequent proliferation of controlled composition clauses); 2/5/08 Tr. 1644:16-16:45:2 (Peer) (stating that controlled composition clauses have developed "a much broader reach" since 1997).

264. Second, even to the limited extent that controlled composition clauses apply to digital music (*i.e.*, to licenses entered prior to 1995), they have no logical bearing on this proceeding. Controlled composition clauses are contractual terms pertaining to licensing contracts that bypass the statutory license at issue in this proceeding. *See, e.g.,* 2/5/08 Tr. 1418:18-1421:7 (Israelite); 2/5/08 Tr. 1663:20-1664:2 (Peer). Since they have no direct bearing on the statutory compulsory license at issue,

and since they are contractual terms that result from voluntary negotiations, they should have no bearing on the Court's determination.

4. A Late-Payment Fee Is Unwarranted

265. The Copyright Owners have also proposed a late payment term under which a fee of 1.5 percent would be assessed every month following the payment due date. *See, e.g.,* CO Written Direct Statement at 12; Faxon WDT ¶ 81(a) (CO Tr. Ex. 3). As Mr. Faxon confirmed, this fee is equivalent to an annual rate of 18 percent. *See* 1/30/08 Tr. 641:8-10 (Faxon). The proposed fee would be disruptive to the industry because for the first time it would subject all licensing to a high financing charge that bears no relationship to the specific licensing arrangement in question. While the particular features or contexts of some licenses may merit a late payment provision, that is no reason to apply such a provision via statute to every license.

266. Indeed, several Copyright Owner witness acknowledged that they could achieve the same through contractual terms. Roger Faxon acknowledged that late payment terms could be included in contracts, *see* 1/29/08 Tr. 497:4-17 (Faxon), and on cross examination he admitted that his company has negotiated agreements containing such provisions in the past. *See* 1/30/08 Tr. 641:17-19 (Faxon). Alfred Pedecine, Senior Vice President and CFO of the Harry Fox Agency ("HFA"), agreed that late payment penalties could be imposed via contract, and he acknowledged that HFA has included them in some contracts. *See* 5/19/08 Tr. 7098:17-21 (Pedecine).

267. The Copyright Owners have presented no evidence demonstrating that it is necessary to achieve the statutory objectives. To the contrary, a late-payment fee imposed by regulation would produce disruptive consequences for licensees, which could have a negative impact on the availability of creative works to the public.

5. The Proposed Pass-Through Fee Is Unjustified and Overbroad

268. The Copyright Owners also propose a mandatory surcharge of three percent on all pass-through licenses. *See, e.g.,* CO Written Direct Statement at 12; Faxon WDT ¶ 81(a) (CO Tr. Ex. 3). The fee was proposed simply because the Copyright Owners "felt it was a reasonable number," with no further support. *See* 2/5/08 Tr. 1471:9-22 (Israelite). This fee would disrupt the industry in the same manner as the proposed late payment fee. While the characteristics of some specific licenses could merit inclusion of a pass-through provision, that does not justify applying such a provision across the board via regulation.

269. Mr. Israelite attempted to justify the three-percent pass through proposal on the ground that the NMPA wants to discourage pass-through arrangements and thereby create an incentive for direct relationships with new digital media entities. *See* 2/5/08 Tr. 1470:17-1471:3 (Israelite). Regardless of the questionable validity of this purported purpose, it does nothing to justify including a pass through provision in the final determination rather than via contract.

270. Further, HFA's Alfred Pedecine revealed that the proposed pass-through fee amounts to overkill relative to the problem it was designed to address. He explained that the Copyright Owners included the fee in their proposal because publishers were having difficulty collecting timely payments on pass-through licenses, but only for uses in the last month of each quarter. *See* 5/19/08 Tr. 7094:19-7095:1 (Pedecine). The proposed fee, he admitted, would impose the three-percent fee to all uses throughout the quarter, not just during the supposedly problematic final month. *See id.* 7095:2-16 (Pedecine). Therefore, as Mr. Pedecine acknowledged in response to questions from the

Court, the pass-through proposal amounts to a three-month solution to a one-month problem. *See id.*

271. Moreover, as with their proposed late-payment fee, the Copyright Owners' proposed pass-through fee suffers from the absence of evidence demonstrating that it is calculated to achieve the statutory objectives. Indeed, the fee would have disruptive consequences that eclipse the problem it was designed to address, and it could therefore effectively reduce the availability of creative works to the public.

6. The Copyright Owners' Expert Economists Fail to Justify the Copyright Owners' Unprecedentedly High Penny-Rate Proposal

272. As explained in greater detail below, neither of the expert economists presented by the Copyright Owners offered a reliable justification for the unprecedentedly high penny-rates the Copyright Owners propose. The first, Dr. Landes, presented a market-based theory that largely ignores the statutory objectives and instead assesses the Copyright Owners' proposal by reference to a uselessly broad range of largely irrelevant comparators. The second, Dr. Murphy, offered a theory with no empirical support or foundation in the industry.

a. William Landes Focused on Replicating a Marketplace Rate, Not Achieving the Statutory Objectives, and For Support He Relied on a Misdirected Analysis of Marketplace Rates for Separate Products

273. Dr. Landes attempted to buttress the Copyright Owners' proposal by demonstrating its reasonableness, but his analysis suffers from several critical failings that severely limit its utility to the Court. Dr. Landes employed an analysis based on free-market outcomes, not the statutory objectives. He also counseled that setting an inappropriately high rate can achieve the free-market objectives he favors because it gives the parties room to bargain among themselves for lower, more appropriate rates.

Moreover, to test the propriety of the Copyright Owners' rate under his market-based analysis, he drew on three benchmarks that have no direct relationship to permanent downloads. Indeed, his analysis of these disparate products produced a range of rates (20 percent to 50 percent of the total "content pool") that is simply too broad to be helpful. And, in assessing these rates, he engaged in a misdirected analysis of the apportionment of the royalty "content pools." Finally, his testimony revealed a pronounced lack of familiarity with key aspects of the mechanical licensing process, and a significant lack of diligence with respect to analyzing pertinent data with requisite care.

274. Market-Based Analysis. First, Dr. Landes approached his task with the view that the Court should attempt to replicate a market rate. He openly questioned the need for a statutory rate-setting process and the role of regulation. *See, e.g.*, Landes WDT ¶ 20 (CO Tr. Ex. 22) ("Today, it is unlikely that concerns about transactions costs or about monopoly power provide economic justification for the compulsory mechanical license. . . ."); 2/7/08 Tr. 2259:4-12 (Landes) ("I think the justification for the statutory rate today is much weaker than it used to be."). While he offered assurance that such criticisms were not the purpose of his analysis, *see id.* 2259:4-14 (Landes), he proceeded to approach his assignment as if the statutory objectives were merely suggestive. *See, e.g.*, *id.* 2077:5-2078:6 (Landes) (explaining that the statutory objectives call for "rates that are likely to prevail in a competitive market").

275. Dr. Landes identified each statutory objective, and he performed a brief analysis of each, but he took care to break them into component parts small enough to shoehorn into a market-based assessment. *See, e.g.,* Landes WDT ¶ 21 (CO Tr. Ex. 22) (asserting that the statutory objectives require the Court to "promot[e] economic

efficiency"); *id.* ¶ 29 (concluding that the first objective suggests erring on the side of higher rates, allowing market forces to subsume the statutory goals); *id.* ¶ 39 ("The economic interpretation of a 'fair' return, which is required by this second objective, is a rate that would be voluntarily negotiated in a market between willing buyers and sellers, and that would be sufficient to cover the full costs of producing and distributing the good. Typically, such a rate would promote access and efficient production of intellectual property."); *id.* ¶ 41 (concluding that the third objective "is consistent with the goal of promoting economic efficiency"); *id.* ¶ 43 (concluding that the fourth objective, like the other three, "can be understood as promoting economic efficiency").

276. In other words, regardless of the actual statutory command, Dr. Landes concluded that each objective merely requires the Court to reach a rate determination that promotes the types of outcomes that result from voluntary negotiations between willing buyers and willing sellers. This approach, of course, is wholly at odds with the applicable statutory objectives, governing regulations, precedent from the Court and predecessor tribunals, and decisions from U.S. Courts of Appeals. *See, e.g.,* Guerin-Calvert WDT ¶ 97 (DiMA Tr. Ex. 7) ("[T]he Section 801(b)(l) standards . . . are distinct from other rate setting objectives that attempt to replicate a market price based on the economic concept of a willingness to pay. Imbedded in the principles of 801(b)(1) is recognition of the interplay among the sides of the market in achieving the specific goals."); *see also Proposed Conclusions of Law of the Digital Media Association ("DiMA") and its Member Companies AOL, LLC; Apple Inc.; MediaNet Digital, Inc.; and RealNetworks, Inc.* § II, Docket No. 2006-3 CRB DPRA (July 2, 2008) (hereinafter "DiMA PCL").

277. Room to Bargain. Reflecting his steadfast view that this proceeding should merely replicate a marketplace result, Dr. Landes testified repeatedly that setting an "excessively high" statutory rate would lead to an acceptable result because it would leave room for industry participants to bargain for a more suitable rate. *See, e.g.,* Landes WDT ¶ 24 (CO Tr. Ex. 22) ("If the statutory rate is higher than a particular user is willing to pay, then the user and publisher have an incentive to agree to a lower rate. Thus, an 'excessively high' statutory rate would probably have only a negligible impact on both incentives to create music and access costs."); *id.* ¶ 26 ("[I]f the statutory rate is higher than the value of the musical work to a potential user, the owner and user will negotiate a mutually beneficial lower rate.").

278. Accordingly, he voiced support for setting rates too high rather than too low. *See, e.g., id.* ¶ 29 ("[T]he principal danger today in setting a statutory rate for a compulsory mechanical license is setting the rate 'too low' rather than 'too high.'"); *id.* ¶ 31 ("Even if the statutory rate exceeds the willingness to pay for some record companies or online music providers, these companies (and ultimately consumers) will not be injured, because they can seek and obtain licenses below the statutory rate."); *id.* ¶ 40 ("A 'high' statutory rate will not reduce access because lower valuing users (i.e., users who value music below the statutory rate) can freely negotiate below that rate.").[15] This is also entirely inconsistent with the record evidence of high transaction costs in the mechanical licensing process. *See infra* ¶¶ 287-298.

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[15] Dr. Landes explained his task in this proceeding as "considering only whether the rate proposed by the NMPA is too high." *See* Landes WDT ¶ 55 n.15 (CO Tr. Ex. 22). In light of his view that an unduly high rate achieves the marketplace results he favors by leaving room to bargain, there is reason to wonder whether Dr. Landes believes it is possible to propose a rate that is "too high."

279. Dr. Landes fundamentally misunderstood the constraints applicable to setting royalty rates in this proceeding. The Court's job is not to replicate a market rate. *See* DiMA PCL § II. And there is ample reason to reject any approach that relies on "bargaining room" theories. *See id.* ¶ 43.

280. Reliance on Non-Comparable Benchmarks. Dr. Landes analyzed the Copyright Owners' proposal by comparing it to the effective rates for three wholly distinct products: synchronization rights, audio home recording rights, and ringtones. *See, e.g.,* Landes WDT ¶¶ 49-51 (CO Tr. Ex. 22). (More specifically, he compared the copyright owners' share of total license under the Copyright Owners' proposal with the copyright owners' share of total license fees in the comparators he selected. *See id.* ¶ 48.) For a variety of reasons, none of the three provides useful guidance in this context, and Dr. Landes himself admitted that two of them – audio home recording rights and ringtones – are particularly weak comparators. *See* 2/7/08 Tr. 2105:19-2106:4 (Landes) (commenting on audio home recording rights); 2/11/08 Tr. 2481:18-2482:7 (Landes) (commenting on ringtone agreements). Since his marketplace evidence pertains to products that have nothing to do with the products at issue here (with the exception of ringtone agreements, which may provide guidance for a ringtone rate), the comparators he suggested provide the Court with little meaningful guidance.

281. First, Dr. Landes turned to synchronization licenses. *See* Landes WDT ¶ 49 (CO Tr. Ex. 22). As he readily explained, however, synchronization licenses govern the right to "'synchronize' a prerecorded song with visual images, such as those in movies, television shows and commercials." *Id.* As explained below, these uses for music are entirely distinct from the uses to which a mechanical right applies. *See infra*

§ IX(E)(2). Moreover, as Dr. Landes confirmed in response to questions from the Court, the purchasers of the rights are different parties in the mechanical context (retailers and distributors) and the synchronization context (television or movie producer). *See* 2/7/08 Tr. 2089:6-18 (Landes). As Dr. Landes acknowledged, those different buyers value the rights they acquire differently. *See id.* 2090:21-2091:3 (Landes). Since synchronization rights have no direct connection to mechanical rights, details about synchronization rates have limited relevance in this proceeding.

282. Second, Dr. Landes turned to the Audio Home Recording Act of 1992 ("AHRA"), which has little bearing on the products and services before the Court. *See id.* Landes WDT ¶ 50 (CO Tr. Ex. 22); *see also infra* § IX(E)(3). Indeed, after explaining that the AHRA reflects a congressional apportionment of royalties with respect to a different basket of rights, Dr. Landes admitted the AHRA is not "quite as useful" as other comparators because "it's not a market; it's legislation." 2/7/08 Tr. 2105:19-2106:4 (Landes); *see also* Wildman WRT at 4, 16 (RIAA Tr. Ex. 87).

283. Third, Dr. Landes assessed the royalty rates in ringtone agreements negotiated in recent years. *See* Landes WDT ¶ 51 (CO Tr. Ex. 22). While these might have relevance to the rate applicable to ringtones if adjusted for their unusual characteristics, there is no support for his assumption that they have any bearing on rates for other products. Indeed, Dr. Landes confirmed unequivocally that ringtones have different supply and demand characteristics than permanent downloads, and he therefore testified that ringtones "are not my strongest comparison." 2/11/08 Tr. 2481:18-2482:7 (Landes); *see also infra* § IX(E)(1) (detailing the differences between ringtones and downloads).

284. Perhaps not surprisingly, Dr. Landes's analysis of these three disparate comparators revealed vastly different apportionments of licensing revenue between publishers and record companies. *See* Landes WDT ¶ 48 (CO Tr. Ex. 22) ("[T]he publisher's share of the total license fees paid for the song and the sound recording ranges from about one-fifth to one-half.") This reflects the fact that rates vary dramatically between distinct products, and that it is therefore inappropriate to use the rate for one product as a guideline for another. *See, e.g.*, 1/30/08 Tr. 626:1-6 (Faxon). "It is not surprising, therefore, that his benchmarks produce a range (20-50% of the total content pool) that is so broad as to be close to meaningless." Wildman WRT at 3 (RIAA Tr. Ex. 87). Indeed, the difference between the low and high ends of the range he identified is equivalent to more than $1 billion in mechanical royalty payments each year – an amount that is more than double the total volume of mechanical royalties ever paid in any year in the United States. *See id.* at 9.

285. As Dr. Wildman testified, even to approximate a market-defined benchmark, "[t]he notion that any rate within such an extremely broad range" would be appropriate "lacks facial credibility." *Id.* at 10; *see also id.* ("[C]onsider a low-end, compact economy car from one of the major auto companies. Would we accept $15,000 and $37,500 as plausible lower and upper bounds for prices that would be both fair to consumers and provide reasonable compensation to auto manufacturers and dealers?"). Dr. Landes failed to recognize this reality, however, and instead labeled the disparate results a "range of reasonableness," Landes WDT ¶ 65 (CO Tr. Ex. 22); *see id.* ¶ 52 (stating that the range "provides information about the reasonable mechanical royalty"),

and concluded that the Copyright Owners' proposed rates are reasonable. *See, e.g., id.* ¶¶ 55, 65, 71, 83, 96.

286. Misdirected "Content Pool" Analysis. As noted, Dr. Landes relied on these three pieces of marketplace evidence to assess the allocations of the licensing "content pool" between copyright owners and copyright users. *See id.* ¶¶ 48-53. But his "content pool" approach, which focuses on the relative payments for mechanical royalties and other royalties, is fundamentally misdirected because it ignores the Section 801(b)(1) objectives. In particular, his analysis turns the third objective upside down. Rather than calculate a rate that reflects relative costs, *see* 17 U.S.C. § 801(b)(1)(C), Dr. Landes's "relative payments" approach assumes that higher royalty costs for non-mechanical rights justify a higher rate for mechanical rights as well. *See, e.g.,* 2/11/08 Tr. 2374:3-4 (Landes) ("[I]t's the relative value that's the key . . . not the absolute value."). As Ms. Guerin-Calvert explained:

> [T]he Section 801(b)(1) statutory objectives do not address the relative value of rights compared with each other. Instead, the statutory objectives focus on the relative compensation due to mechanical rights copyright owners and users given their relative contributions to the actual final product made available to the public. For this reason, it is my opinion that Professor Landes' use of a content pool approach is misdirected and inconsistent with the statutory objectives.

Guerin-Calvert WRT ¶ 22 (DiMA Tr. Ex. 10). By employing an analytical approach that conflicts with the requirements of the statute, Dr. Landes has generated conclusions that provide little useful guidance to the Court.

287. Unfamiliarity with Mechanical Licensing. Dr. Landes's live testimony revealed a pronounced lack of knowledge about the statutory process for obtaining a compulsory license and the voluntary process for obtaining a license from HFA. While

he asserted as a foundation for his analysis that "transactions costs likely are low," Landes WDT ¶ 20 (CO Tr. Ex. 22); *see also id.* ¶¶ 27-28, his testimony demonstrated his complete unfamiliarity with the direct costs and transactions costs associated with the compulsory and voluntary processes. *See, e.g.*, 2/7/08 Tr. 2115:12-2119:20 (Landes) (in response to questions from the Court, expressing confusion about the transactions costs under the statutory regime and the voluntary licensing process administered by HFA); *id.* 2121:5-2122:20 (Landes) (in response to questions from the Court, stating that copyright owners and users pay commissions to HFA to account for the transactions costs avoided); *id.* 2129:22-2130:19 (Landes) (stating that he learned more about the HFA process during the lunch break following the morning hearings, and attempting to correct his previous statements); *id.* 2268:8-2271:12 (Landes) (admitting lack of knowledge about how much or by what process, if any, copyright owners and copyright users compensate HFA); 5/20/08 Tr. 7279:17-7280:14 (Landes) (confirming that he has no knowledge of the transactions costs under the compulsory licensing regime); *id.* 7283:17-7285:4 (Landes) (confirming, in response to questions from the Court, that he has not considered all relevant indicia of transactions costs under the compulsory regime); *id.* 7471:17-22 (Landes) (confirming that he has not assessed the transactions costs associated with the compulsory licensing process).

288. In contrast to Dr. Landes, Andrea Finkelstein, Sony BMG Music Entertainment's Senior Vice President for Business Affairs Operations and Administration, has a great deal of familiarity with the licensing process. She testified that there are in fact significant transactions costs associated with negotiating mechanical licenses outside of the compulsory process. *See* A. Finkelstein WRT at 26-28 (RIAA Tr.

Ex. 84). She explained, for example that HFA does not have authorization to grant reduced-rate licenses for most works, so each publisher who controls a share of the pertinent work must grant the reduced rate. *See id.* This involves a time-consuming process of negotiation with each publisher. Indeed, Sony BMG "has determined that incurring the transaction costs of seeking reduced-rate licenses can seldom be justified in the case of single-disk products that are anticipated to sell fewer than [50,000] units." *Id.* at 28. Ms. Finkelstein also highlighted the error of Dr. Landes's assertion that "record companies pay commissions or fees to HFA in connection with mechanical licenses." *See id.* at 28. Sony BMG, her employer, does not pay any such fees or commissions. *See id.*

289. Dr. Landes based his opinion on fundamental – yet misinformed – assumptions about the relative ease of the voluntary licensing process relative to the compulsory process. *See, e.g.,* Landes WDT ¶¶ 27-28 (CO Tr. Ex. 22); 2/7/08 Tr. 2112:19-2113:20 (Landes). His lack of understanding about how either process actually works – particularly with respect to comparative transactions costs – undermines the foundation of his analysis and therefore raises questions about the validity of his conclusions.

290. Failure to Analyze Data with Requisite Care. Finally, during the rebuttal phase of the proceeding, Dr. Landes confirmed that his analysis of mechanical royalties paid to songwriters suffered from errors. *See, e.g.*, 5/19/08 Tr. 7150:12-7161:9, 7175:22-7183:10 (Landes) (describing the errors). In performing the analysis, which was designed to show the impact of a changed mechanical rate on songwriters, *see* 5/19/08 Tr. 7112:8-7113:5 (Landes), Dr. Landes and his staff analyzed royalty payments for specific

songs from Universal Music Publishing Group to songwriters from 2000-2006. *See* Landes WRT ¶ 15 (CO Tr. Ex. 406). Due to a "truncation problem," to use Dr. Landes's phrase, the data for royalty payments in 2005 and 2006 were limited to 99,999 songs for each year. *See* 5/19/08 Tr. 7150:15-7151:11, 7153:9-13 (Landes) (explaining the extent of the truncation problem). And due to a coding error in the program Dr. Landes and his staff used to analyze the data, any song that did not appear in the data for either year "disappeared from the analysis." *Id.* 7153:22-7154:1 (Landes).

291. As a result of this error, Dr. Landes improperly excluded approximately 37,000 songs from his analysis. *See id.* 7154:12-7155:21 (Landes). If a particular songwriter received royalties for only a single song in either 2005 or 2006, and if those payments fell out of the top 99,999 in either year, that songwriter was eliminated from the study entirely – regardless of how much revenue the songwriter might have received in earlier years. *See id.* 7159:20-7160:18 (Landes). Dr. Landes acknowledged that it is impossible to determine how many songwriters (and consequently how much mechanical income) was excluded as a result of this error. *See id.* 7160:19-7161:3 (Landes).

292. While Dr. Landes attempted to fix the problem, he did not go back to Universal Music Publishing to retrieve complete data. Instead, he simply assigned proxy values to the missing 37,000 songs and ran the analysis again. *See id.* 7176:11-7178:11 (Landes). While he maintains that the resulting differences are negligible, *see id.* 7176:18-7179:14 (Landes), he presented his "corrected" analysis – based on assumptions, not actual data – just two days before he took the stand to testify. *See id.* 7179:15-22 (Landes). Taken as a whole, the pervasive errors in Dr. Landes's mechanical royalty

study, and his inadequate efforts to correct them at the eleventh hour, raise questions about the overall reliability of Dr. Landes's conclusions and their utility to the Court.

b. Kevin Murphy Ignores Critical Empirical Evidence, Focuses on Market Forces Rather than Statutory Objectives, and Improperly Disregards the Value of Distribution Innovations

293. The Copyright Owners presented the testimony of a second economist – Dr. Kevin Murphy – with respect to two narrowly circumscribed questions: whether reductions in sales and prices of CDs make the current mechanical rate too high, and whether controlled composition clauses are relevant to determining the appropriate statutory rate. *See* K. Murphy WRT ¶ 8 (CO Tr. Ex. 400) (explaining the limits of his testimony). While his testimony was much narrower than that of Dr. Landes, it provided little useful guidance to the Court for four principle reasons.[16]

294. First, while Dr. Murphy was quick to theorize that a penny-rate methodology reflects market processes more completely than a percentage rate, *see, e.g., id.* ¶ 13, he admitted that he has done very little work with respect to the recorded music industry. *See* 5/15/08 Tr. 6918:7-12, 6919:7-22 (K. Murphy). He offered no analysis of – or explanation for – the overwhelming empirical evidence that rebuts his theory as applied in this context. The facts presented in this proceeding reveal that the United States stands virtually alone in applying a penny rate to mechanical rights payments, while a percentage rate applies in virtually every other nation (regardless of the existence of regulatory oversight of mechanical licensing). *See, e.g., supra* § VII(A)(5); *infra*

[16] The analysis in this section covers only the first question addressed by Dr. Murphy. With respect to the second, the record reflects the Copyright Owners' understanding that controlled composition clauses should have no impact on the rate for digital products. *See supra* ¶¶ 262-263.

§ IX(C). Dr. Murphy's failure to address or even consider uncontroverted facts that undermine his theoretical approach raises questions about the reliability of his conclusions.

295. Second, while Dr. Murphy presented his theory to buttress the Copyright Owners' opposition to a percentage-rate system, one of the key tenets of his analysis undermines the utility of employing a penny rate instead. In particular, Dr. Murphy argued against a percentage rate on the ground that it establishes a fixed ratio between the compensation allocated to copyright owners and copyright users. *See* K. Murphy WRT ¶ 13 (CO Tr. Ex. 400). The fixed nature of the rate, he contended, results in a flawed compensation system because it does not account for changes over time in the relative market values of songwriting and song distribution. *See id.*; *see also* 5/19/08 Tr. 7016:5-17 (K. Murphy). But, as Dr. Murphy conceded during the rebuttal hearings, a penny rate suffers from the same flaw. *See* 5/19/08 Tr. 7016:5-17 (K. Murphy). Since a penny rate is fixed, it cannot adjust alongside market fluctuations either.

296. Dr. Murphy's theory, therefore, undermines both of the methodologies – penny rates and percentage rates – that the Court has at its disposal. This is hardly surprising since, like Dr. Landes, his economic analysis focuses on market-based outcomes, not the statutory objectives that govern the Court's determination. *See id.* 6873:11-19 (K. Murphy) (stating that his analysis tested how the mechanical rate would change "if it were determined in a free marketplace rather than set according to statute, [which is] a question about how market prices would evolve in response to one of the major changes we have seen in the industry recently"). As with Dr. Landes's analysis, Dr. Murphy's market-focused approach that disregards the statutory objectives has little

value in light of the statutory requirements, the Copyright Royalty Board's governing regulations, precedent from the Court and predecessor tribunals, and decisions from U.S. Courts of Appeals. *See* DiMA PCL § II.

297. Third, Dr. Murphy's theory disregards the consumer-friendly innovative contributions of legal digital distributors. He conceded in his live testimony that legal distributors boost revenues for copyright owners when their investments result in consumer-friendly features that lure consumers away from pirated alternatives. *See* 5/19/08 Tr. 7019:7-7021:8 (K. Murphy). While he acknowledged that these innovative services could decrease the value consumers place on "the old distribution methods" that came before, he did not consider the proper valuation of – or compensation for – the newer innovative services. *See id.* 7021:5-8 (K. Murphy). Indeed, his analysis is entirely devoid of any assessment of the contribution of innovative distribution services, and he ignores the importance of stimulating more distribution innovations in a marketplace, like this one, that is overshadowed by piracy.

298. Finally, Dr. Murphy premised his theoretical construct on the erroneous assumption that musical compositions and distribution are economic complements. *See* K. Murphy WRT ¶ 11 (CO Tr. Ex. 400). That assumption was critical to his analysis, which turned on a corresponding economic principle: "an increase in the supply of or reduction in the cost of providing" one economic complement will "rais[e] the demand for and the market price of" the other. *Id.* The problem with Dr. Murphy's assumption, however, is that it does not reflect the actual relationship between songs and digital music distribution. As Ms. Guerin-Calvert pointed out, songs and digital distribution are joint inputs, not economic complements. *See* 5/6/08 Tr. 4818:12-18 (Guerin-Calvert); *see also*

5/8/08 Tr. 5339:21-5340:14, 5344:6-5346:14 (Slottje) (observing that music is one among many joint inputs into the final product). As a result, the economic principle on which Dr. Murphy relied – namely, that an increase in supply or decrease in price of one input will raise the demand and price of the other – has no bearing on the industry he purported to analyze.

7. The Copyright Owners' Industry Experts Are Unqualified to Support the Copyright Owners' Proposals, and Their Testimony Fails to Justify the Copyright Owners' Unprecedentedly High Penny Rate

299. The Copyright Owners also presented testimony from two "industry experts": Claire Enders and Helen Murphy. As the record reveals, however, neither was qualified to offer support for the Copyright Owners' proposal or to testify in the expert capacities that the Copyright Owners proffered. Moreover, the fact testimony they presented fails to justify the uniquely high penny-rate that the Copyright Owners have proposed.

a. The Record Reveals the Unreliability of Claire Enders's Conclusions, and Her Testimony Demonstrates the Unreasonableness of the Copyright Owners' Proposal

300. As revealed during the direct case hearings, Claire Enders lacks the qualifications to testify on the limited subject for which she was called, and – in any event – her testimony is riddled with unsupported assumptions that undermine its reliability. Moreover, to the limited extent her testimony was reliable, it succeeded only in demonstrating the unreasonableness of the Copyright Owners' proposal.

301. The Copyright Owners presented the testimony of Ms. Enders – admitted as an expert in the development, current state, and likely future prospects for the digital music industry, *see* 2/4/08 Tr. 1135:21-1137:6 (Enders) (proffer and acceptance of expert

qualification) – for a single purpose: to justify their proposal to set the mechanical rate for "digital phonorecord deliveries . . . higher than that set for physical phonorecords." Enders WDT at 4 (CO Tr. Ex. 10) (explaining the narrow reach of her testimony). The Court sustained an objection to her qualifications to opine as an expert on that discrete question, however, and all references to her opinion on the subject were stricken from the record. *See* 2/4/08 Tr. 1138:14-1139:5 (Enders) (the objection), 1147:1-3 (Enders) (sustaining the objection and ordering deletion of sections subject to it).

302. In addition to her insufficient qualifications, Ms. Enders acknowledged repeatedly in responses to inquiries from the Court that her entire analysis regarding the future of the industry relies on a litany of assumptions rather than facts. *See* 2/4/08 Tr. 1253:4-1277:14 (Enders).[17] Her extensive reliance on untested judgments and assumptions demonstrated that she did not present the Court with a fact-based analysis.

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[17] A review of this portion of her testimony reveals that Ms. Enders's pervasive reliance on untested or undocumented assumptions afflicts virtually every aspect of her analysis. *See, e.g.,* 2/4/08 Tr. 1256:2-5 (assumed growth rate for digital music players); *id.* 1259:13-21 (assumed growth rate for monthly digital music purchases); *id.* 1260:15-17 (relied on assumptions regarding digital music purchases); *id.* 1261:15-18 (assumed changes in the number of album units purchased per buyer per year); *id.* 1262:1-3 (assumed changes in the number of music videos purchased per buyer per year); *id.* 1263:8-10 (assumed changes in the price for permanent downloads of a single); *id.* 1263:21-1264:1 (assumed changes in the price for permanent downloads without digital rights management restrictions); *id.* 1264:4-9 (assumed changes in the price for downloaded albums); *id.* 1264:15-16 (assumed changes in the price for downloaded music videos); *id.* 1266:2-5 (assumed growth in handset penetration); *id.* 1266:16-18 (assumed growth rate for mobile downloads); *id.* 1268:15-19 (assumed growth in the percentage of handsets that can play a full track of music); *id.* 1269:11-22 (assumed changes in the number of people willing to pay to download ringtones); *id.* 1270:8-13 (assumed changes in the number of consumers who want full track downloads on the mobile phones); *id.* 1272:10-13 (assumed changes in ringtone prices); *id.* 1273:6-8 (assumed changes in prices for full tracks downloaded to mobile phones); *id.* 1275:18-21 (assumed changes in broadband penetration).

See id. 1350:20-1351:6 (Enders) (confirming that replicating the results she achieved would require reliance on the same judgment she used).

303. Moreover, far from supporting the Copyright Owners' proposal, Ms. Enders's testimony demonstrated its unreasonableness and the importance of setting the mechanical rate for digital products at a comparatively low level.

304. First, Ms. Enders noted that consumers place greater value on digital music than on physical recordings. *See* Enders WDT at 5-6 (CO Tr. Ex. 10). While there is abundant evidentiary support demonstrating this enhanced value of digital music, *see, e.g.,* 1/29/08 Tr. 516:2-7 (Faxon) (noting that features of digitally distributed music "make it a better product, and therefore, a product that is more valuable to consumers"), nothing in the record supports the conclusion that it somehow justifies higher per-unit or percentage royalty payments to copyright owners. To the contrary, the record reflects that copyright owners perform precisely the same functions in the digital and physical worlds, *see supra* ¶ 255, meaning that their contributions are immaterial to consumers' differing valuations. Legal digital distributors, by contrast, have invested tens of millions of dollars to develop service enhancements that improve the end-user experience and attract consumers. *See supra* §§ III(B); IV(A).

305. Indeed, Ms. Enders herself identified several features that attract consumers to digital services, including 24-hour availability, immediate access to purchased music, access to comprehensive catalogs, portability, and the ease of sampling. *See* Enders WDT at 59-60 (CO Tr. Ex. 10). These features – the very ones she admits enhance the value of digital music – are the result of digital distributors' investments, innovations, and risks. *See supra* § IV(A). When applied to the actual evidence,

therefore, Ms. Enders's reasoning leads to the conclusion that the rate should be *lower* for digital products than for physical products in order to reflect the greater contribution of legal digital distributors.

306. Ms. Enders also focused only on consumers' perceived value without recognizing the marketplace realities that result from piracy. As the record clearly reflects, the price that legal digital distributors can charge for digital music is constrained by competition from the free pirated alternative. *See supra* §§ II(A)(2); V(D). As a result, regardless of how much more consumers prefer the digital product, it is impossible to capture that increased value through higher prices. Concluding, as Ms. Enders does, that copyright owners should receive an oversized payment for these products all the same would simply increase legal digital distributors' costs and, perversely, cede more of the marketplace to illegal piracy. *See supra* ¶¶ 136-137.

307. Second, Ms. Enders asserted that it is much cheaper to produce and distribute digital downloads than physical products. *See* Enders WDT at 6 (CO Tr. Ex. 10). Her assertion breaks down, however, in the face of the technological investments legal distributors must make, the costs they must bear, and the risks they must face in order to maintain a toehold in the recorded music industry. *See supra* § V; *see also* Cue WDT ¶5 (DiMA Tr. Ex. 3) (Apple incurred significant risk and invested tens of millions of dollars in launching and growing an online music store in a marketplace universally viewed as insecure and facing brutal competitive pressures); Sheeran WRT ¶¶ 7-8 (DiMA Tr. Ex. 11) (describing the massive investments required to remain competitive). While there is no dispute that digital distributors are not saddled with the cost of manufacturing CDs, that fact alone is not enough to support her sweeping conclusion that

legal digital distributors do not bear costs comparable to producers and distributors of physical products.

308. She failed to explain, moreover, why any distribution efficiencies generated through innovations and investments should not result in greater returns for the parties that created them. Again, there is no dispute that copyright owners do nothing in the digital context that differs from their role in the physical context. *See supra* ¶ 255. Since digital distributors have undertaken the investments and borne the risks that have allowed legal digital distribution to flourish, *see supra* § V(B), (C), the rate should reflect their greater contribution.

309. Third, Ms. Enders suggested that the mechanical rate should somehow make up for the fact that permanent downloads can be sold as singles as well as bundled albums. *See* Enders WDT at 6-7 (CO Tr. Ex. 10). While Ms. Enders and the Copyright Owners bemoan this apparent trend, it is in reality another feature of digital music that attracts consumers. *See supra* § IV(B)(3). Ms. Enders's theory therefore rests on the unsupported and anti-consumer assumption that it is appropriate to require the public to buy songs in bundles – including songs they may not want – in order to purchase any given track. There is no evidence to support the conclusion that unbundling has had a negative impact on gross demand for music. *See supra* ¶¶ 122-123. Indeed, Ms. Enders herself presents sales data indicating that digital album sales are rising much more quickly than digital singles sales, meaning that the unbundling phenomenon on which she rests her theory is becoming less and less pronounced with time. *See supra* ¶ 125.

b. The Pervasive Errors in Helen Murphy's Written Statement and Her Failure to Inform the Court of Their Existence Render Her Testimony Unreliable

310. The Copyright Owners also presented testimony from Helen Murphy, a music publishing executive. *See* Murphy WDT (CO Tr. Ex. 15). The Copyright Owners proffered her as an expert in the recorded music business. 2/6/08 Tr. 1743:22-1746:13. Subsequent discovery of numerous errors in her testimony led the Court to reject her expert testimony. *Order Striking Certain Witness Testimony and Refusing Witness as Expert* at 1, Docket No. 2006-3 CRB DPRA (Feb. 14, 2008). In light of the errors that riddled her testimony and the impact they had on her status as an expert, Ms. Murphy's testimony in support of the Copyright Owners' proposal ought to be rejected in its entirety.

IX. RECORD EVIDENCE OF RATES FROM COMPARABLE CONTEXTS SUPPORTS ADOPTION OF THE RATES DiMA PROPOSES

311. Throughout the hearings, each party presented the Court with evidence of rates and methodologies that apply in contexts that the sponsoring party contended are comparable to this one. The most useful benchmarks are the most comparable ones, and the use and selection of benchmarks must by guided by the statutory objectives.

312. An assessment of the benchmarks proposed in this proceeding reveals that the most relevant comparators support the growth-encouraging percentage rate proposed by DiMA and undermines the growth-inhibiting penny rate proposed by the Copyright Owners. In particular, the rate in force in the United Kingdom – which was established very recently for a comparable set of rights among a comparable group of parties – provides compelling evidence that DiMA's proposed rate for digital downloads is reasonable and appropriate. *See infra* § IX(B). By contrast, the various benchmarks

suggested by the Copyright Owners have only limited bearing on the rights and rates at issue here, and they therefore provide no support for the Copyright Owners' proposal.

A. Evidence of Rates Adopted in Comparable Contexts Provides Information That Can Assist the Court in Reaching an Appropriate Determination

313. As DiMA explains in greater detail in its Proposed Conclusions of Law, rates in force in royalty payment contexts comparable to this one can provide valuable guidance in the rate determination process. *See* DiMA PCL § III(E); *see also* 2/13/08 Tr. 2939:19-22 (Boulton) ("I always use comparables from overseas where I rely upon them as being cross-checks rather than being determinative."). Not all suggested comparisons are equally useful, however. "[T]he most informative benchmarks," Ms. Guerin-Calvert explained, "are those that involve most closely analogous rights to those at issue in this proceeding and similar ranges of participants for comparable digital music use." Guerin-Calvert WRT ¶ 4 (DiMA Tr. Ex. 10).

314. As explained below, the settlement agreement recently adopted in the United Kingdom fits this description. On the other end of the spectrum, "among the less informative potential benchmarks are agreements involving only single pairings of participants, 'start-up' agreements, or those involving different products than those at issue in this proceeding." Guerin-Calvert WRT ¶ 4 (DiMA Tr. Ex. 10). Each of the various comparables suggested by the Copyright Owners provides relatively little guidance to the Court for precisely these reasons.

B. The U.K. Settlement Agreement Provides the Most Reliable and Informative Benchmark

315. In late 2006, representatives of copyright owners, record labels, and digital music distributors reached two settlement agreements with respect to the mechanical and

performing rights royalties that copyright users must pay to copyright owners in the United Kingdom. *See, e.g.,* Guerin-Calvert WDT ¶ 26 (DiMA Tr. Ex. 7). The first addressed licensing between record labels and copyright owners in the United Kingdom, and it also covered licensing to the iTunes Store and certain mobile service providers. *See* Boulton WDT ¶ 3.2 (RIAA Tr. Ex. 54); RIAA Tr. Ex. 53, attach. D-106-DP (Settlement Agreement dated Sept. 28, 2006). The second covered licensing to Napster and MusicNet. *See, e.g.,* Boulton WDT ¶ 3.4 (RIAA Tr. Ex. 54); McGlade WDT Ex. I (DiMA Tr. Ex. 5) (Settlement Agreement dated Oct. 6, 2006). These agreements, frequently referred to collectively as the U.K. Settlement Agreement, provide particularly valuable guidance in this proceeding because they reflect a very recent agreement in a comparable marketplace among comparable parties over a comparable basket of rights.

1. Comparable Market

316. The U.K. Settlement Agreement is a relevant comparator for purposes of this proceeding in part because of the similarities between the recorded music industries and markets in the two countries. *See, e.g.,* Taylor WDT at 5-7 (RIAA Tr. Ex. 53). Both countries, for instance, have "extremely significant record markets," with the United Kingdom "second only to the U.S. in the number of albums released per year." *Id.* The United Kingdom is also the third-leading country for both total worldwide retail revenue and digital music sales, behind only the U.S. and Japan. *See id.*

317. In addition, market participants in both countries "invest particularly heavily in the areas of A&R and marketing and promotion of records; much more so than is typically done in other countries." *Id.* at 5-6. Beyond production and promotion of physical products, market participants "in both countries are also investing in developing

a legitimate online music market, while at the same time facing and fighting similar significant online piracy problems." *Id* at 6.

318. Moreover, unlike much of the rest of the world, the U.K. and U.S. music industries "are both very international in focus." *Id.* at 6. Indeed, "[t]he U.K. recording industry is behind only the U.S. in number of records distributed or licensed abroad." *Id.*

2. Comparable Parties

319. The U.K. Settlement Agreement is also particularly useful because it reflects an agreement among the same categories of parties – copyright owners, record labels, and legal digital music distributors – that are actively participating in this proceeding. *See, e.g.,* Boulton WDT ¶ 3.10 (RIAA Tr. Ex. 54). In particular, the U.K. Settlement Agreement resolved licensing rate disputes among the British Phonographic Industry Limited (a record company trade association whose members include the major record labels), the Mechanical-Copyright Protection Society Limited (which distributes royalties to the owners of mechanical rights), and several legitimate digital distributors including iTunes, Napster, and MusicNet. *See, e.g.,* Boulton WDT ¶¶ 2.5, 2.11, 3.2, 3.4 (RIAA Tr. Ex. 54); *see also* Taylor WDT at 10-11 (RIAA Tr. Ex. 53).

3. Comparable Basket of Rights

320. Finally, the U.K. Settlement Agreement provides particularly valuable guidance because it covers mechanical rights for permanent downloads – the same rights and products at issue here. Under the terms of the U.K. Settlement Agreement, the copyright users agreed to pay the copyright owners a total royalty fee of 8 percent of applicable revenues for permanent downloads. *See* RIAA Tr. Ex. 53, attach. D-106-DP at 39-40, § 2.1 (Settlement Agreement dated Sept. 28, 2006); Boulton WDT at 14, Table 2 (RIAA Tr. Ex. 54). That total royalty fee includes payments for both mechanical rights

and performance rights. *See, e.g.,* Taylor WDT at 14 (RIAA Tr. Ex. 53); Boulton WDT ¶ 3.14 (RIAA Tr. Ex. 54).[18]

321. To convert the total U.K. royalty fee for permanent downloads into a figure that is relevant to this proceeding, therefore, it is necessary to determine how much is apportioned to mechanical rights and performing rights respectively. As several witnesses have testified, the royalty collecting societies in the United Kingdom divide the total royalty fee by allocating 75 percent to the holders of mechanical rights and 25 percent to the holders of performance rights. *See, e.g.,* Taylor WDT at 14 (RIAA Tr. Ex. 53); Boulton WDT ¶ 4.23 (RIAA Tr. Ex. 54); 2/13/08 Tr. 2937:11-2938:17 (Boulton). As a result, the effective payment for mechanical rights for permanent downloads is 6 percent (75 percent of 8 percent). *See, e.g.,* Taylor WDT at 14 (RIAA Tr. Ex. 53).

322. One of the Copyright Owners' witnesses, Mr. Fabinyi, the Managing Director of Mechanicals at the MCPS-PRS Alliance in the United Kingdom, prepared a chart that demonstrates exactly how to extract the mechanical payment from the total royalty rate for digital music in the United Kingdom. *See* Fabinyi WRT, attach. F-2 (CO Tr. Ex. 380). Mr. Fabinyi's chart lists sixteen countries (including the United Kingdom) and identifies for each the total royalty rate applicable to digital music sales. With respect to fourteen of the countries listed (including the United Kingdom), the rates listed in the third column of the chart incorporate payments to the holders of mechanical rights

[18] Related to the percentage rate royalty, the U.K. Settlement Agreement also includes provisions requiring minimum per-unit payments. *See* Taylor WDT at 11-13 (RIAA Tr. Ex. 53). As Mr. Taylor explained, "it is expected that the percentage rate will be the operative rate in most situations" notwithstanding the inclusion of minima. *See id.* at 13.

and performance rights. *See id.*; *see also* 5/15/08 Tr. 6852:7-20 (Fabinyi).[19] In response to questions about the chart, Mr. Fabinyi explained that for any of those thirteen countries, multiplying the total royalty rate listed in the third column by the "mechanical" proportion listed in seventh column reveals "how much was distributed as a mechanical right." 5/15/08 Tr. 6853:9-16 (Fabinyi).

323. For the United Kingdom, the total royalty rate for sales of permanent downloads is listed in the third column as 8 percent of the retail price, and the portion allocated to mechanical payments is listed in the seventh column as 75 percent. *See* Fabinyi WRT, attach. F-2 (CO Tr. Ex. 380); *see also id.* ¶ 16 (noting that the U.K. royalty is calculated by reference to retail price). Applying the mechanical portion to the total royalty rate reveals that "the effective amount that's distributed to the owner of the mechanical right is 6 percent." 5/15/08 Tr. 6853:21-6854:20 (Fabinyi).[20] The minimum fees in the U.K. agreement do not apply at current price points – they are real minima intended to provide downside protection, not an alternative rate calculation. *See* 2/12/08 Tr. 2908:16-21 (Boulton).

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[19] In one of the fourteen, Switzerland, 100 percent of the total royalty is provided to holders of mechanical rights and 0 percent is provided to holders of performance rights. While this is not actually a division of the total royalty, the percentage figures are subject to the Protective Order because Mr. Fabinyi's sources in Switzerland requested confidential treatment of this information. *See* 5/15/08 Tr. 6784:20-6786:4 (Fabinyi).

[20] In the United Kingdom, the mechanical and performing rights societies deduct a 12.5 percent commission from the total royalty payment before anything is distributed to copyright holders. *See* 5/15/08 Tr. 6823:12-19 (Fabinyi). Thus, the total royalty pool passed through to mechanical and performance rights holders is only 7 percent of revenues, not the full 8 percent listed on Mr. Fabinyi's chart (because deducting 12.5 percent from 8 percent leaves 7 percent). *See id.* 6823:20-6824:8 (Fabinyi). Since the mechanical portion of the total royalty is 75 percent in the United Kingdom, mechanical royalty recipients actually receive 75 percent of 7 percent of revenues, which amounts to 5.25 percent. *See id.* 6824:20-6825:6 (Fabinyi).

324. As explained in detail above, in this proceeding DiMA has proposed a rate of 6 percent for permanent downloads, and it has proposed penny minima with the expectation that the percentage rate will be the operative rate in most situations. *See supra* § VIII(A)(1). The agreement reached in the United Kingdom – under which mechanical rights holders receive royalty payments equal to 6 percent of retail revenues, with penny minima provisions that are not expected to apply in most cases – directly supports DiMA's proposal.

325. In an attempt to show that the mechanical rates in force in the United Kingdom (and elsewhere in the world) are not appropriate comparators for this proceeding, Mr. Fabinyi argued that "the United States is distinct from most of the rest of the world because of the prevalence of 'controlled composition clauses'." Fabinyi WRT ¶ 13 (CO Tr. Ex. 380). Because of controlled composition clauses, Mr. Fabinyi asserted, "the statutory mechanical rate [in the United States] is the functional equivalent of a ceiling," while the rate in the United Kingdom "serves as the actual rate." *Id.* ¶¶ 13, 16.

326. As numerous witnesses explained, however, controlled composition clauses have no bearing on permanent downloads for musical works licensed since 1995. *See supra* ¶¶ 262-263. Indeed, Mr. Fabinyi himself recognized as much. *See* Fabinyi WRT ¶ 5 n.1 (CO Tr. Ex. 380). Accordingly, regardless of whether the prevalence of controlled composition clauses affects the relevance of the U.K. rate for physical products, they have no impact on the relevance of the U.K. mechanical rate applicable to permanent downloads.

327. Mr. Fabinyi further attempted to distinguish the rates in force in the United Kingdom (and elsewhere in Europe) on the ground that they apply uniformly and

without variation to every party. *See* 5/15/08 Tr. 6817:13-6818:12 (Fabinyi). The United States differs, he asserted, because there is always room to negotiate down from the compulsory rate set by statute. *See id.* He revealed the weakness of this reasoning, however, by acknowledging that the purported distinction applies only with respect to voluntary licenses in the United States. *See id.* 6818:13-6819:17 (Fabinyi). While parties may enter voluntary agreements with varying rates in this country, the rates applicable under the compulsory mechanical license are fixed and binding – just like the rates in force in the United Kingdom and elsewhere in Europe. *See id.* The comparable mechanical rates in the United Kingdom are therefore informative.

C. Evidence of Mechanical Rates in Other Developed Countries Undercuts the Copyright Owners' Proposal

328. The United Kingdom is hardly the only country in which mechanical rights holders receive payments equal to roughly 6 percent of retail revenue for licensing permanent downloads. Rather, testimony from Copyright Owners' witnesses revealed that developed countries around the world employ percentage rates for mechanical rights payments for permanent downloads. *See, e .g.,* Fabinyi WRT, attach. F-2 (CO Tr. Ex. 380); 1/31/08 Tr. 1091:6-9 (Robinson) (agreeing that "mechanical royalties are paid on a percentage basis virtually with every other country in the world"). In other words, evidence adduced by the Copyright Owners themselves demonstrated the extent to which their proposal amounts to an unprecedented arrogation of industry revenues.

329. The troubling uniqueness of the Copyright Owners' penny-rate proposal was revealed in attachment F-2 to Mr. Fabinyi's testimony, which presents a survey of other developed countries and the corresponding range of royalty rates they apply to permanent downloads. *See* Fabinyi WRT, attach. F-2 (CO Tr. Ex. 380); 5/15/08 Tr.

6817:3-7 (Fabinyi) (explaining the scope of attachment F-2). As explained below, the data from the survey demonstrate that none of the rates in use in those countries approaches the rate or methodology proposed by the Copyright Owners.[21] (To the contrary, in fact, they are very close to the rate proposed by DiMA in this proceeding.)

330. In his live testimony, Mr. Fabinyi explained how to extract the "mechanical" portion from the total royalty rate in the countries on his chart in which a total royalty is apportioned between mechanical and performance rights. *See* 5/15/08 Tr. 6854:21-6855:6 (Fabinyi). Table 1, which follows this paragraph, lists the results of the process for the United Kingdom and the 13 additional countries with aggregated royalties. Table 1 also includes Canada, which is listed on Mr. Fabinyi's chart but does not require any mathematical conversion since the Canadian rate applies to mechanical rights alone. *See* Fabinyi WRT, attach. F-2 (CO Tr. Ex. 380); *see also* 5/15/08 Tr. 6830:18-21 (Fabinyi) (confirming that the mechanical rate for digital downloads is 8.8 percent of retail price).

[21] The rates reflected in Mr. Fabinyi's chart are the highest potentially applicable rates in each country. *See* 5/15/08 Tr. 6843:19-6844:3 (Fabinyi).

Country	Total Rate (A)[22]	Portion Paid to Owner of Mechanical Right (B)[23]	Effective Payment Rate to Owner of Mechanical Right (A x B)
Austria	8%	67%	5.36%
Belgium	8%	67%	5.36%
Canada	8.8%	n.a.	8.8%
Denmark	12%	70%	8.4%
Finland	8%	70%	5.6%
France	8%	75%	6%
Germany	15%	67%	10%
Ireland	8%	75%	6%
Japan	7.7%	65%	5.005%
Netherlands[24]	8%	75%	6%
Norway	8%	70%	5.6%
Spain	8%	50%	4%
Sweden	8%	70%	5.6%
Switzerland	8%	100%	8%
U.K.	8%	75%	6%

TABLE 1

331. As Table 1 demonstrates, each of the fifteen countries listed by Mr. Fabinyi employs a percentage-of-revenue approach to mechanical licensing for permanent downloads.[25] Of the fifteen, eleven have effective mechanical rates that fall

[22] The data in this column were taken from column 3 on Mr. Fabinyi's chart. *See* Fabinyi WRT, attach. F-2 (CO Tr. Ex. 380).

[23] The data in this column were taken from column 7 on Mr. Fabinyi's chart. *See* Fabinyi WRT, attach. F-2 (CO Tr. Ex. 380).

[24] Mr. Fabinyi's chart lists the royalty rate for the Netherlands as 10 percent. *See* Fabinyi WRT, attach. F-2 (CO Tr. Ex. 380). As he explained on the errata sheet attached to his written statement and during his live testimony, the rate should have been listed as 8 percent. *See* Fabinyi WRT, Errata Item #4 (Co Tr. Ex. 380); 5/15/08 Tr. 6855:13-17 (Fabinyi).

[25] Moreover, while these countries employ minima in addition to the percentage rate royalties, they provide downside protection and do not apply at current price levels. *See* 5/15/08 Tr. 6951:21-6952:5 (Fabinyi).

within the 4-6 percent range.[26] This is the same range that Ms. Guerin-Calvert described as a reasonable range for a mechanical rate determination in this proceeding. *See* Guerin-Calvert WDT ¶ 122 (DiMA Tr. Ex. 7) ("Economic analyses of the digital media industry, including assessment of business models, investments, consumer patterns, and income and incentives for both copyright holders and users, support a rate methodology based on a percentage of retail revenues at the low end of a 4-6% range."). Of the remaining four – 8 percent, 8.4 percent, 8.8 percent, and 10 percent – none, when applied to today's 99-cent permanent download price, approaches the unprecedented 15-cent inflation-adjusted rate proposed by the Copyright Owners. *See supra* ¶ 253.

332. If nothing else, the data contained in Mr. Fabinyi's chart and supporting testimony demonstrate that the Copyright Owners' proposed rate is completely unlike anything adopted elsewhere in the developed world.[27] Not only do the Copyright Owners propose the solitary penny rate among these developed nations, but they also suggest a stratospheric rate level that eclipses the comparable rate in place anywhere else in the world. Indeed, Mr. Fabinyi confirmed that he is not aware of any country anywhere in the world with a mechanical rate as high as the rate proposed by the Copyright Owners in this proceeding. *See* 5/15/08 Tr. 6846:15-20 (Fabinyi).

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[26] Of the eleven within the 4-6 percent range, four are exactly the same as the 6 percent rate proposed by DiMA for permanent downloads, and seven others are lower than the DiMA proposal. *See* Table 1, above.

[27] Mr. Fabinyi's data also suggest that the mechanical rate embodied in the U.K. Settlement Agreement is not an outlier cherry-picked by DiMA because it produces the best outcome. (Indeed, if that had been DiMA's goal, it should have selected one of the several with rates under 6 percent.) Rather, these data indicate that there is an accepted band for mechanical rates for permanent downloads around the world, and the effective mechanical rate in the United Kingdom falls squarely within it. Since the U.K. Settlement Agreement provides valuable guidance in this proceeding, this supports DiMA's view that the rate adopted by this Court for permanent downloads should fall within the accepted band as well.

D. The 1981 CRT Decision

333. The Copyright Royalty Tribunal's first mechanical rate determination – litigated in 1980 and issued in 1981 – also serves as a useful source of analytical guidance. *See* Adjustment of Royalty Payable Under Compulsory License for Making and Distributing Phonorecords; Rates and Adjustment of Rates, 46 Fed. Reg. 10,466 (Copyright Royalty Tribunal, Feb. 3, 1981) ("1981 CRT Determination"). In particular, the 1981 CRT Determination provides valuable "background and context for the current proceeding" because it achieved the same four statutory objectives that must be achieved in this proceeding. Guerin-Calvert WDT ¶ 19 (DiMA Tr. Ex. 7); *see also id.* ¶ 28 ("Central to the 1980/81 Section 115 decision as well as to the issues before the CRB today are the implications of the chosen rate methodology for the accomplishment of the four objectives."). In other words, the 1981 CRT Determination is relevant because it was "the last time the statutory objectives had been rigorously applied and upheld on appeal in connection with the license at issue in this proceeding." *Id.* ¶ 20; *see also* Landes WDT ¶ 7 (CO Tr. Ex. 22) ("The last litigated proceeding to set a compulsory license rate took place in 1980.").

334. In addition to providing context for how the industry has changed over time, the 1981 CRT Determination provides insight into an appropriate rate. The original determination was equivalent to approximately 5 percent of the prevailing retail price, representing a relative allocation of revenues to copyright owners and users. *See* Guerin-Calvert WDT ¶ 23 (DiMA Tr. Ex. 7) ("The CRT set the compulsory rate at 4 cents per track, or approximately 5.0% of the retail price, assuming a physical album retailing at $7.98 and 10 tracks per album."). Not only was this decision affirmed on appeal, but the relative allocation was twice ratified by the industry through voluntary agreements in

1987 and 1997. *See, e.g.,* Landes WDT ¶ 7 (CO Tr. Ex. 22). Beginning in the late 1990s, however, legitimate music sales began to free fall. *See supra* ¶ 67. The radical transformation of industry conditions since then points decidedly towards a different allocation of revenues and a lower rate compared to 1981. *See* Guerin-Calvert WDT ¶¶ 16, 24 (DiMA Tr. Ex. 7); Guerin-Calvert WRT ¶ 26 (DiMA Tr. Ex. 10).

E. The Comparators Identified by the Copyright Owners Provide Less Guidance Than the U.K. Settlement Agreement, and None Provides Support for the Unprecedentedly High Rates They Propose

335. In an effort to convince the Court to adopt the highest mechanical rates in history and unlike any other anywhere in the world, *see supra* ¶ 332, the Copyright Owners have adduced evidence regarding a smattering of proposed comparators that have only limited relevance to the rights at issue in this proceeding or the parties to which they apply. While the Court should consider all evidence required by the statutory objectives in reaching its rate determination, an assessment of the Copyright Owners' proposed "benchmarks" reveals that none provides guidance in achieving the objectives in this context.

1. Ringtone Agreements

336. Over the course of the direct and rebuttal hearings, the Copyright Owners stuffed the record with a collection of more than 130 assorted ringtone agreements. *See, e.g.,* Robinson WDT, attachs. 101-125 (CO Tr. Ex. 8) (25 ringtone agreements); Faxon WDT, attach. 218 (CO Tr. Ex. 3) (59 ringtone and mastertone agreements); Peer WDT, attachs. 151-53, 155-168, 170-173, 176-77 (CO Tr. Ex. 13) (23 ringtone agreements); Firth WDT, attachs. 252, 295-329, 344, 351, 375-422) (CO Tr. Ex. 24) (28 ringtone agreements). The Copyright Owners suggest that these ringtone agreements should serve

as a benchmark for the Court's determination of rates for permanent downloads. *See, e.g.*, Faxon WDT ¶¶ 55-59 (CO Tr. Ex. 3); Landes WDT ¶ 51 (CO Tr. Ex. 22).

a. Ringtone Agreements Do Not Provide Useful Guidance

337. While evidence of rates from ringtone agreements might be relevant to the determination of a mechanical rate for ringtones themselves – after substantial adjustments to reflect the unique circumstances under which the agreements were negotiated – it has no relevance to completely unrelated products such as permanent downloads. As the Copyright Owners admit, the product is itself unique. A ringtone is "a snippet of a sound recording or digital file of a musical work of up to 30 seconds in length that is downloaded to a mobile phone or similar device to personalize its ring." CO Written Direct Statement at 11 n.7.

338. Dr. Landes – who relied heavily on ringtone rates in developing his expert report, *see* Landes WDT ¶ 51 (CO Tr. Ex. 22) – acknowledged that ringtones and permanent downloads are different products, and he therefore testified that ringtones "are not my strongest comparison." 2/11/08 Tr. 2481:18-2482:7 (Landes); *see also supra* ¶ 283. Ms. Guerin-Calvert reached the same conclusion, noting that "[r]ingtones are highly differentiated from permanent . . . downloads with different supply and demand conditions." Guerin-Calvert WRT ¶ 24 (DiMA Tr. Ex. 10). "Consumers," she explained, "would not consider ringtones to be substitutes for downloads, or vice versa." *Id.*

339. Several other witnesses confirmed that the product characteristics of ringtones and downloads are different in numerous critical respects. Richard Boulton and Claire Enders both testified that ringtones are used only to personalize mobile phones. *See* 2/13/08 Tr. 2953:8-9 (Boulton) ("Ringtones are essentially about personalizing a

mobile phone."); 2/4/08 Tr. 1159:8-14 (Enders) ("[R]ingtones . . . are sold by mobile operators to their customers . . . as an identifier on the mobile phone."). Their price points are very different from the price points for downloads. *See, e.g.,* 2/13/08 Tr. 2953:10-11 (Boulton); 2/4/08 Tr. 1272:18-19 (Enders) (testifying that ringtones are not a price sensitive product); *id.* 1273:3-5 (Enders) (testifying that ringtone prices are very stable).

340. Ringtones are also distinct from permanent downloads because only the most popular songs are marketed as ringtones. *See, e.g.,* 1/28/08 Tr. 224:4-15 (Carnes) (confirming that ringtones are mostly hit songs); 1/30/08 Tr. 610:10-15 (Faxon) (acknowledging that the ringtone market focuses "on songs that have wide appeal"); 2/5/08 Tr. 1698:2-12 (Peer) (acknowledging that the ringtone agreements attached to his testimony list only popular songs). And they typically consist of 30 seconds of music, *see* 2/13/08 Tr. 2953:9-10 (Boulton); 2/4/08 Tr. 1159:9-10 (Enders), focusing on the song's catchiest "hook." *See* 2/4/08 Tr. 1159:9-11 (Enders). As a result, the ringtone catalog is entirely different (and much more "hit" concentrated) than the vast catalog of music available as permanent downloads.

341. In addition, many ringtone agreements were originally negotiated to cover only monophonic and polyphonic recordings – that is, snippets of tunes played via computerized tones. *See, e.g.,* 1/30/08 Tr. 608:22-609:3 (Faxon). As a general matter, they did not cover mastertones, which are snippets from recording artists' actual renditions of songs. *See id.* 611:13-19 (Faxon). As a result, these agreements often covered "works" that are wholly different from the works available via permanent

download, and the copyright users participating in this proceeding had nothing to do with their negotiations. *See id.* 608:18-21 (Faxon).

342. Furthermore, many of these agreements were negotiated when the ringtone "market" was in its very early stages, and "[g]aining market access to this new product would likely have influenced greatly the negotiation of rates." Guerin-Calvert WRT ¶ 24 (DiMA Tr. Ex. 10).

343. Moreover, the Copyright Owners themselves have implicitly recognized that ringtones are not suitable comparator for other products. By proposing a three-tiered rate for ringtones that is different from the rates proposed for other digital products (and completely distinct from the penny rate they proposed for permanent downloads), *see* CO Written Direct Statement at 11-12, the Copyright Owners have acknowledged that ringtone rates are not suitable proxies.

344. For these reasons, the rates that were negotiated for ringtones have no direct bearing on the rates that should apply to permanent downloads, and they therefore are not a highly relevant comparator.

b. New Digital Media Agreements Do Not Provide Useful Guidance

345. Witnesses presented by the Copyright Owners also suggested that New Digital Media Agreements ("NDMAs") can serve as a useful benchmark because they are essentially a subset of ringtone agreements. *See, e.g.,* Faxon WDT ¶¶ 60-65 (CO Tr. Ex. 3). NDMAs are omnibus agreements between individual publishers and individual labels that typically cover rights and payments for "mastertones" and other digital products such as dual discs, locked content products, master ringbacks, and digital video products. *See,*

e.g., Faxon WDT ¶ 60 (CO Tr. Ex. 3); 1/29/08 Tr. 446:13-447:3, 452:16-20, 457:21-458:1 (Faxon) (describing services covered by NDMAs).

346. Like agreements that cover only ringtones, NDMAs are largely irrelevant to the Court's determination of rates for digital downloads since the NDMAs do not cover rights and rates for such products. Instead, they cover a variety of other products. *See* Faxon WDT ¶ 60 (CO Tr. Ex. 3) (listing the products covered by NDMAs), and the record is devoid of any evidence suggesting that rates applicable to those unrelated products are somehow relevant to digital downloads. In this regard Roger Faxon testified that "the NDMA agreements do not relate to permanent downloads," and he therefore acknowledged that "it would be hard for [NDMAs] to necessarily support" the Copyright Owners' rate proposal for permanent downloads. 1/30/08 Tr. 625:10-12 (Faxon). It is difficult to draw inferences from particular agreements about extraneous products or services because "each individual product needs to be seen in its own light" due to "[d]ifferent market conditions, different market structures." 1/30/08 Tr. 626:1-6 (Faxon).

2. Synchronization Agreements

347. The Copyright Owners also suggested that synchronization agreements provide useful guidance. *See, e.g.*, Landes WDT ¶ 49 (CO Tr. Ex. 22); *see also* Faxon WDT ¶ 73 (CO Tr. Ex. 3) (suggesting that synchronization rights provide evidence of market rates). More specifically, Dr. Landes relied on the rates embodied in several synchronization agreements to conclude that music publishers and record labels have a track record of splitting the total content pool evenly. *See* Landes WDT ¶ 49 (CO Tr. Ex. 22); *see supra* ¶ 281.

348. The market for synchronization rights is wholly dissimilar from the market for mechanical rights associated with permanent downloads (or any other form of

recorded music sales). In essence, the difference boils down to the fact that "music is put to an entirely different use when rights are licensed by movie and television producers for inclusion in a film, television show, or advertisement than when music is distributed in the form of a sound recording." Wildman WRT at 4 (RIAA Tr. Ex. 87). Indeed, in the synchronization context "sound recordings are themselves merely inputs into the creation of motion pictures and television programs," while permanent downloads are stand-alone consumer products. *See id.* at 14. Moreover, the purchasers of synchronization rights (television or movie producers) are different from the purchasers of mechanical rights, and they value the rights they acquire differently. *See* 2/7/08 Tr. 2089:6-2091:3 (Landes). Accordingly, synchronization agreements provide relatively little guidance to the Court in establishing the mechanical rate for those products in this proceeding.

3. The Audio Home Recording Act

349. Dr. Landes's analysis also included an assessment of the AHRA, which among other things established the royalty rates associated with licenses for audio home recording rights. *See* Landes WDT ¶ 50 (CO Tr. Ex. 22); *see supra* ¶ 282. Using the AHRA as a benchmark in this proceeding suffers from two critical flaws. First, as Dr. Landes acknowledged, the AHRA covers "royalties on digital recording devices and media," not mechanical rates for permanent downloads. *See* Landes WDT ¶ 50 (CO Tr. Ex. 22); *see also* Guerin-Calvert WRT ¶ 25 (DiMA Tr. Ex. 10) ("[T]he marketplace for digital audio recording rights is not comparable to permanent . . . downloads at issue in this proceeding, and therefore, does not provide an appropriate benchmark in setting royalty rates for mechanical rights.").

350. Second, and perhaps more importantly, the AHRA does nothing more than "reveal[] Congress's view" of allocating royalties for other purposes. Landes WDT ¶ 50

(CO Tr. Ex. 22); *see also* Guerin-Calvert WRT ¶ 25 (DiMA Tr. Ex. 10) (noting that the AHRA allocation of royalties "is not an allocation that is market-based or that reflects the statutory objectives"); Wildman WRT at 4 (RIAA Tr. Ex. 87). But Congress expressly did not make a legislative choice on the allocation of mechanical royalties for permanent downloads. Instead, it entrusted the Court with determining rates and terms that achieve the 801(b) objectives. As a result of this fundamental shortcoming, Dr. Landes conceded during his live testimony that the AHRA has relatively little utility as a comparator. 2/7/08 Tr. 2105:19-2106:4 (Landes). For these reasons, the royalty rates that Congress chose to apply to digital audio recording right have very limited relevance to the rate determination at issue in this proceeding.

X. DiMA'S PROPOSED RATES AND TERMS ARE REASONABLE AND CALCULATED TO ACHIEVE EACH OF THE STATUTORY OBJECTIVES

351. The record clearly supports DiMA's proposed rates and terms. Given widespread access to free pirated music, the price of music offerings must be low enough for sellers to attract buyers. *See supra* § III(A)(2). Potential buyers are attracted by innovative and ever-improving offerings, which require consistent investment and risk-taking. *See supra* §§ IV(A); V(C). This puts pressure on margins, which in turn requires digital music distributors to keep costs as low as possible. *See supra* § V(D). Imposing higher fixed penny rates in this industry would impede expansion and kill nascent entry. *See supra* ¶ 136-137; § VII(B). A percentage-of-revenue rate structure with a rate set at a lower, entry-enhancing level would best achieve all of the statutory objectives. *See supra* § VII(A). The U.K. Settlement Agreement provides a directly relevant benchmark in this regard, and this approach is broadly consistent with the prior proceeding to set rates for this license. *See supra* § IX(B), (D).

352. First, Section 801(b)(1)(A) requires the Court to set a rate that "maximize[s] the availability of creative works to the public." The record demonstrates that digital distribution of music is the only sector of the recorded music industry with the potential to grow. DiMA member companies and other legal digital distributors are increasing legitimate sales of music and expanding the music marketplace. *See supra* § III(B)(2). Not only do these efforts benefit consumers, they also expand sales and revenues for copyright owners. *See supra* § IV(B), (C). But growth remains fragile. *See supra* § V(A), (C). DiMA's proposed rates are the most ideally suited to maximize the availability of creative works to the public. *See supra* § VIII(A)(1). In particular, lower rates (not higher rates), and percentage-of-revenue rate structures (with true minima – not confiscatory minima that set unreasonable pricing floors) are the most sensible approach to growing the music market and ensuring maximum compensation to copyright owners. *See supra* §§ VII(A); VIII(A).

353. Second, Section 801(b)(1)(B) requires the Court to set a rate that provides fair compensation to copyright owners and copyright users "under existing economic conditions." Without question, sustained and continued entry by digital music providers is the most important bulwark against piracy. *See supra* §§ III(B)(2); IV(C). Adopting rates that will allow legitimate distributors to expand legitimate sales (and displace pirated distribution) will increase the return for all industry participants. *See supra* § IV(C). Costs and risks are high for digital music distributors. *See supra* § V. In particular, piracy places downward pressure on prices and upward pressure on costs for these companies. *See supra* § III(A)(2). Evidence of a single successful digital music distributor does not indicate that rates can be increased dramatically without subverting

this statutory objective. *See supra* § VIII(A)(4). Establishing a rate unduly focused on greater compensation for any individual copy sold, without considering its impact on total sales and the influence of existing economic conditions, will result in lower income for everyone. *See supra* ¶¶ 251-258.

354. Third, Section 801(b)(1)(C) requires the Court to set a rate to "reflect the relative roles of the copyright owner and copyright user in the product made available to the public." For purposes of the rates and terms DiMA has proposed, digital music distributors play the most important role relative to "technological contribution, capital investment, cost, risk, and contribution to the opening of new markets for creative expression and media for their communications." 17 U.S.C. § 801(b)(1)(C); *see also supra* §§ IV(A); V(B). These contributions should be reflected in a lower mechanical rate. Moreover, in a digital music marketplace that is undergoing rapid change, the "relative roles" of copyright owners and users can change in unforeseen ways. Accordingly, the Court should adopt a percentage-of-revenue rate structure – as opposed to a penny rate – which will continue to reflect these relative roles in the future. *See supra* § VII.

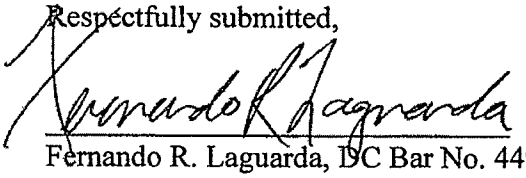
355. Fourth, Section 801(b)(1)(D) requires the Court to set a rate that minimizes the disruptive impact on industry structure and prevailing practices. Rampant Internet piracy already causes massive disruption in the recorded music business, and particularly with respect to sales of permanent downloads. *See supra* § III(A). In setting rates and terms for permanent downloads, therefore, the Court must be sensitive to this marketplace reality and its effect not only on existing copyright users, but also on potential new entrants to which these rates and terms will apply. *See supra* ¶¶ 32-33.

Contrary to the high penny rate and minimum fee proposed by the Copyright Owners, DiMA's proposed rates and terms for permanent downloads have the potential to reduce this disruptive effect for the benefit of all. *See supra* § VIII.

CONCLUSION

356. DiMA's Second Amended Proposed Rates and Terms best achieve the statutory objectives. The rates and terms proposed by the Copyright Owners would be disastrous for the industry and fail to do anything except ignore the record evidence. For the foregoing reasons, the Court should adopt DiMA's Second Amended Proposed Rates and Terms.

Respectfully submitted,



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July 2, 2008

Counsel for The Digital Media Association

APPENDIX A

SECOND AMENDED PROPOSED RATES AND TERMS OF DiMA

Add the following to Chapter III of title 37, Code of Federal Regulations (tentatively numbered part 380 for purposes of reference):

PART 380 – RATES AND TERMS UNDER COMPULSORY LICENSE FOR MAKING AND DISTRIBUTING A DIGITAL PHONORECORD DELIVERY

Sec.

§ 380.1 General.

This part 380 establishes rates and terms of royalty payments for all copies made in the course of making and distributing phonorecords, including by means of digital phonorecord delivery, in accordance with the provisions of 17 U.S.C. 115.

§ 380.2 Definitions.

(a)(1) *Applicable receipts* means that portion of the money received by the licensee, or licensee's carrier(s), from the provision of a digital phonorecord delivery that shall be comprised of the following:

(i) revenue recognized by the licensee from residents of the United States in consideration for the digital phonorecord delivery in accordance with the provisions of 17 U.S.C. 115; and

(ii) the licensee's advertising revenues attributable to third party advertising "in download", being advertising placed immediately at the start, end or during the actual delivery of a digital phonorecord, less advertising agency and sales commissions.

Note: Notwithstanding (i) and (ii), above, the licensee may pro-rate or allocate revenue on the basis of total usage of digital phonorecord deliveries of sound recordings or on any other reasonable basis that fairly and accurately reflects the revenues attributable to particular uses. For example, if revenue is received for a bundle or package, the licensee may allocate revenues on the basis of usage (if DPDs comprise half of total usage, then half of all revenues are attributed to them).

(2) Applicable receipts shall include such payments as set forth in paragraph (a) of this section to which the licensee, or licensee's carrier, is entitled but which are paid to a parent, majority-owned subsidiary or division of the licensee.

(3) Applicable receipts shall exclude:

(i) revenues attributable to the sale and/or license of equipment and/or technology, including bandwidth, including but not limited to sales of devices that receive or perform the licensee's digital phonorecord deliveries and any taxes, shipping and handling fees therefore;

(ii) royalties paid to the licensee for intellectual property rights;

(iii) sales and use taxes, shipping and handling, credit card and fulfillment service fees paid to third parties;

(iv) bad debt expense; and

(v) advertising revenues other than those set forth in paragraph (a)(1)(ii) of this section.

(b) *Digital phonorecord delivery* means a digital phonorecord delivery as defined in 17 U.S.C. 115(d).

(c) *Permanent digital phonorecord delivery* means a digital phonorecord delivery that is distributed in the form of a download that may be retained and played on a permanent basis.

(d) *Licensee* means a person or entity that has obtained a compulsory license under 17 U.S.C. 115 and the implementing regulations therefore to make and distribute phonorecords, including by means of digital phonorecord delivery.

(e) *Licensee's carriers* means the persons or entities, if any, authorized by Licensee to distribute digital phonorecord deliveries to the public.

(f) *Licensed work* means the nondramatic musical work embodied or intended to be embodied in a digital phonorecord delivery made under the compulsory license.

§380.3 Royalty Rates.

(a) For a permanent digital phonorecord delivery, the royalty rate payable shall be the greater of (i) 6% of applicable receipts or (ii) 4.8 cents per track for single tracks or 3.3 cents per track for tracks sold as part of a single transaction including more than a single track ("bundles").

(b) In any case in which royalties must be allocated to specific musical works under subsection (a), each unique musical work's share shall be determined on a pro rata basis.

(c) In any future proceeding under 17 U.S.C. 115(c)(3)(C) or (D), the royalty rates payable for a compulsory license for any digital phonorecord deliveries shall be established de novo, and no precedential effect shall be given to the royalty rate payable under this paragraph for any period prior to the period as to which the royalty rates are to be established in such future proceeding.

§380.4 Scope of statutory license.

A compulsory license under 17 U.S.C. 115 extends to, and includes full payment for, all reproductions necessary to engage in activities covered by the license, including but not limited to:

(a) the making of reproductions by and for end users;

(b) all reproductions made in the normal course of engaging in such activities, including but not limited to masters, reproductions on servers, cached, network, and buffer reproductions.

Before the
COPYRIGHT ROYALTY JUDGES
LIBRARY OF CONGRESS
Washington, D.C.

In the Matter of Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding	Docket No. 2006-3 CRB DPRA

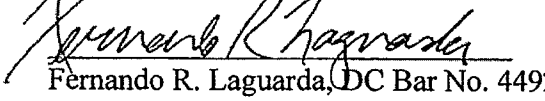
DECLARATION AND RULE 11 CERTIFICATION OF FERNANDO R. LAGUARDA

I am counsel for the Digital Media Association ("DiMA") in Docket No. 2006-3 CRB DPRA and authorized to submit this declaration in support of the foregoing "Proposed Findings of Fact of the Digital Media Association; AOL, LLC; Apple Inc.; MediaNet Digital, Inc.; and RealNetworks, Inc." ("DiMA PFF").

I am familiar with the restricted information set forth in the DiMA PFF, and I have also reviewed the definitions and terms provided in the Protective Order. *See Protective Order*, Docket No. 2006-3 CRB DPRA (March 3, 2007). As explained in detail in the attached redaction log, the Court has already applied the Protective Order with respect to each piece of information identified as restricted (via shading) in the DiMA PFF. Consequently, such information has been treated as "Restricted" in the DiMA PFF, and good cause exists for such treatment.

Under the Copyright Royalty Judges' Rules and Procedures, 37 C.F.R. § 350.4(e)(1), and in compliance with Section 10(b) of the Protective Order, I declare that the Court has applied the Protective Order to all information treated as "Restricted" in the DiMA PFF (designated via shading). Pursuant 28 U.S.C. § 1746 and consistent with the requirements of Rule 11, I hereby declare under penalty of perjury that, to the best of my knowledge, information, and belief, the foregoing is true and correct.

Respectfully submitted,



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July 2, 2008

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Before the
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LIBRARY OF CONGRESS
Washington, D.C.

In the Matter of Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding	Docket No. 2006-3 CRB DPRA

REDACTION LOG

Restricted Information Contained in the Proposed Findings of Fact of the Digital Media Association; AOL, LLC; Apple Inc.; MediaNet Digital, Inc.; and RealNetworks, Inc

Location in Document	Description and Reason for Redaction
¶ 45, lines 13-14	Universal Music Group presentation including information regarding company strategy related to digital distribution. RIAA motion for application of Protective Order granted upon showing made in open court on February 6, 2008. *See* 2/6/08 Tr. 1749:10-1753:1-5 (H. Murphy).
¶ 48, line 6	Universal Music Group presentation including information regarding company strategy related to digital distribution. RIAA motion for application of Protective Order granted upon showing made in open court on February 6, 2008. *See* 2/6/08 Tr. 1749:10-1753:1-5 (H. Murphy).
¶ 67, line 4	Universal Music Group presentation including information regarding company strategy related to digital distribution. RIAA motion for application of Protective Order granted upon showing made in open court on February 6, 2008. *See* 2/6/08 Tr. 1749:10-1753:1-5 (H. Murphy).
¶ 69, line 4	Universal Music Group presentation including information regarding company strategy related to digital distribution. RIAA motion for application of Protective Order granted upon showing made in open court on February 6, 2008. *See* 2/6/08 Tr. 1749:10-1753:1-5 (H. Murphy).

¶ 70, line 4	Universal Music Group presentation including information regarding company strategy related to digital distribution. RIAA motion for application of Protective Order granted upon showing made in open court on February 6, 2008. *See* 2/6/08 Tr. 1749:10-1753:1-5 (H. Murphy).
¶ 72, lines 1-3	Universal Music Group presentation including information regarding company strategy related to digital distribution. RIAA motion for application of Protective Order granted upon showing made in open court on February 6, 2008. *See* 2/6/08 Tr. 1749:10-1753:1-5 (H. Murphy).
¶ 73, lines 7-8	Universal Music Group presentation including information regarding company strategy related to digital distribution. RIAA motion for application of Protective Order granted upon showing made in open court on February 6, 2008. *See* 2/6/08 Tr. 1749:10-1753:1-5 (H. Murphy).
¶ 116, lines 5-8	Sales data pertinent to a particular artist's recordings. DiMA motion for application of Protective Order granted upon showing made in open court on February 26, 2008. *See* 2/26/08 Tr. 4592:19-4597:4 (Quirk).
¶ 153, line 5	RealNetworks, Inc.'s annual expenditures on content acquisition. DiMA motion for application of Protective Order granted upon showing made in open court on February 26, 2008. *See* 2/26/08 Tr. 4592:19-4597:4 (Quirk).
¶ 156, line 7	RealNetworks, Inc.'s annual expenditures related to ingesting new works into its catalog. DiMA motion for application of Protective Order granted upon showing made in open court on February 26, 2008. *See* 2/26/08 Tr. 4592:19-4597:4 (Quirk).
¶ 165, lines 4-6	Napster, Inc.'s annual marketing budget. RIAA and DiMA motions for application of Protective Order granted February 4, 2008. *See* 2/4/08 Tr. 1147:7-1153:4 (Enders).
¶ 176, lines 5-6	Recent financial results for MediaNet Digital, Inc. DiMA motion for application of Protective Order granted upon showing made in open court on February 25, 2008. *See* 2/25/08 Tr. 4406:14-22 (McGlade).

¶ 176, lines 7-9	Recent financial results for MediaNet Digital, Inc. DiMA motion for application of Protective Order granted upon showing made in open court on February 25, 2008. *See* 2/25/08 Tr. 4358:10-4362:8 (McGlade).
¶ 177, lines 3, 8, 11	Recent financial results for MediaNet Digital, Inc. DiMA motion for application of Protective Order granted upon showing made in open court on February 25, 2008. *See* 2/25/08 Tr. 4358:10-4362:8 (McGlade).
¶ 249, lines 10-15	Contribution margins for Apple's iTunes Store. RIAA and DiMA motions for application of Protective Order granted February 4, 2008. *See* 2/4/08 Tr. 1147:7-1153:4 (Enders).
¶ 288, line 12	Number of units that Sony BMG must anticipate selling to justify licensing transactions costs. RIAA motion for application of Protective Order granted upon showing made in open court on May 12, 2008. *See* 5/12/08 Tr. 5633:12-5638:19 (A. Finkelstein).
¶ 322 n.19, lines 1-3	Data regarding division of total royalty rates between mechanical and performance royalties in Switzerland. Copyright Owners' motion for application of Protective Order granted upon showing made in open court on May 15, 2008. *See* 5/15/08 Tr. 6882:2-6886:4 (Fabinyi).
¶ 330, Table 1	Data regarding division of total royalty rates between mechanical and performance royalties in 13 countries. Copyright Owners' motion for application of Protective Order granted upon showing made in open court on May 15, 2008. *See* 5/15/08 Tr. 6882:2-6886:4 (Fabinyi).
¶ 331, lines 3-5 & n.26 lines 6-8	Data regarding effective mechanical payments in several foreign countries. Copyright Owners' motion for application of Protective Order granted upon showing made in open court on May 15, 2008. *See* 5/15/08 Tr. 6882:2-6886:4 (Fabinyi).
¶ 346, lines 7-9, 11-12	Testimony regarding active New Digital Media Agreements. Oral testimony provided during confidential session pursuant to application of the Protective Order. *See* 1/30/08 Tr. 618:3-15, 625:10-12, 626:1-6 (Faxon).

CERTIFICATE OF SERVICE

I hereby certify that on this 2nd day of July 2008, I caused a true and correct copy of the foregoing RESTRICTED version of the "Proposed Findings of Fact of the Digital Media Association; AOL, LLC; Apple Inc.; MediaNet Digital, Inc.; and RealNetworks, Inc." to be served by email and overnight mail on the following:

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July 2, 2008

By Hand Delivery, Overnight FedEx, and First-Class Mail

Ms. LaKeshia Brent
United States Copyright Office
James Madison Memorial Building, LM-401
101 Independence Avenue S.E.
Washington, DC 20059-6000

In the matter of Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding, 2006-3 CRB DPRA

To the Copyright Royalty Judges:

The Digital Media Association ("DiMA"), pursuant to the Court's Scheduling Order of November 20, 2007, submits three filings with this letter.

First, DiMA submits an original, five copies, and a copy on CD of the RESTRICTED version of the "Proposed Findings of Fact of the Digital Media Association ("DiMA") and its Member Companies AOL, LLC; Apple Inc.; MediaNet Digital, Inc.; and RealNetworks, Inc." Pursuant to the Court's Protective Order, DiMA will file a redacted version for public disclosure within three business days.

Second, DiMA submits an original, five copies, and a copy on CD of the "Proposed Conclusions of Law of the Digital Media Association ("DiMA") and its Member Companies AOL, LLC; Apple Inc.; MediaNet Digital, Inc.; and RealNetworks, Inc." This document does not contain materials subject to the Protective Order.

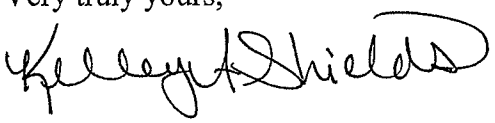
Third, pursuant to 37 C.F.R. § 351.4(b)(3) and the Court's Order of May 27, 2008 on the Joint Motion to Adopt Procedures for Submission of Partial Settlement, DiMA submits with this letter an original and five copies of its Second Amended Proposed Rates and Terms, as well as one copy of the same on CD in PDF format.

ATTACHED NOTES

Don't Post
the
Restricted
Off this Disk

DiMA has enclosed one additional copy of each of these filings for date-stamping. Please do not hesitate to contact me if you have any questions or concerns regarding the foregoing or the enclose materials. Thank you.

Very truly yours,



Kelley A. Shields

Enclosures